CONGRESS OF THE UNITED STATES
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# The Economic and Budget Outlook: An Update

## A Report to the Senate and House Committees on the Budget

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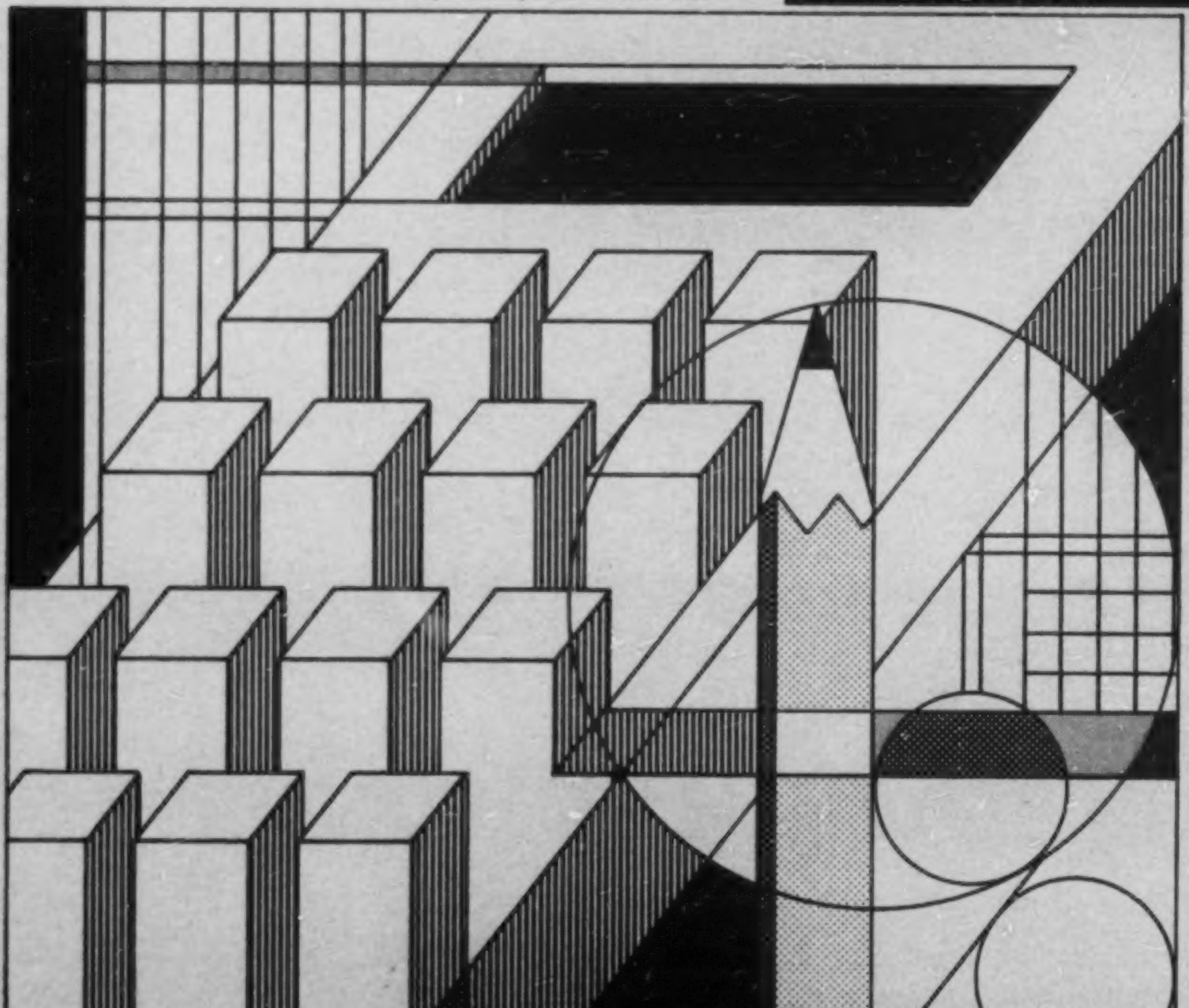

# THE ECONOMIC AND BUDGET OUTLOOK:

# AN UPDATE

The Congress of the United States
Congressional Budget Office

## NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

# PREFACE

This volume is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations.

Chapter I of this report was prepared by the Fiscal Analysis Division under the direction of William J. Beeman and Jacob S. Dreyer, with the assistance of Robert A. Dennis, Victoria S. Farrell, Douglas R. Hamilton, George R. Iden, Stephen A. Parker, John F. Peterson, Martin A. Regalia, Frederick C. Ribe, Frank S. Russek, Jr., Matthew A. Salomon, John R. Sturrock, Stephan S. Thurman, Suzanne Cooper, Lucia S. Foster, Eng Meng Tan, and Bragi Valgeirsson.

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Director

August 1986

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# SUMMARY

Despite the current subdued state of the economy, the Congressional Budget Office (CBO), like most forecasters, projects brisker economic growth by the end of 1986. In the year ahead, employment is forecast to rise steadily and the unemployment rate to decline. Inflation is projected to rise as the effects of the oil price decline gradually dissipate and the effects of rising import prices begin to be felt throughout the domestic price structure. Interest rates are expected to rise modestly, and net exports to improve.

In the meantime, however, the weakness of the economy, reduction in inflation, and more rapid than expected spending for several federal programs have caused a worsening of the short-run budget outlook. CBO estimates that the federal deficit for this fiscal year will reach a record level of $224 billion, up from $212 billion in 1985. While the deficit is projected to decline in 1987, it will still substantially exceed the target of $144 billion established by the Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act). Under CBO's short-run forecast, the baseline deficit projection for 1987 is $184 billion. Under the same economic assumptions but the policy assumptions specified in the Balanced Budget Act, CBO estimates a base deficit of $173 billion. Even under the policies of the Congressional Budget Resolution, the 1987 deficit would still be $161 billion, as shown in Summary Figure 1.

At the time this report goes to press, the near-term economic outlook is particularly uncertain. Indicators of domestic output growth reflect continuing weakness; prospects for a significant increase in capital spending remain mediocre; real consumer spending is unlikely to continue growing at the extremely rapid pace of the second quarter; and the timing and magnitude of any turnaround in net exports are still quite uncertain. Moreover, the projected large cuts in federal spending and the proposed tax reform add another layer of uncertainty to the near-term outlook.

The economy slowed in the second quarter of the year to a meager 1.1 percent growth rate after a relatively strong first quarter when gross national product (GNP) grew at a 3.8 percent rate. Some components of GNP have been quite volatile, making it difficult to ascertain whether the slowdown is likely to be transitory or prolonged.

- o A surge in oil imports in the second quarter, attributable to the need to replenish low inventories, reduced net exports by about $16 billion (1982 dollars).
- o Auto production was cut back sharply to curtail excessive inventories, subtracting 0.7 percentage point from the GNP growth rate in the second quarter.

Although oil imports are likely to continue at high levels, the oil inventory adjustment seems to be largely completed, and auto production schedules for the third quarter call for substantial increases from the levels of the previous quarter. The result could be a snapback leading to a one-time surge in economic growth.

More fundamental reasons for projecting a pickup in the quarters immediately ahead are to be found in economic developments since the beginning of the year. They include a decline in interest rates, lower inflation, the drop in petroleum prices, and further depreciation of the dollar.

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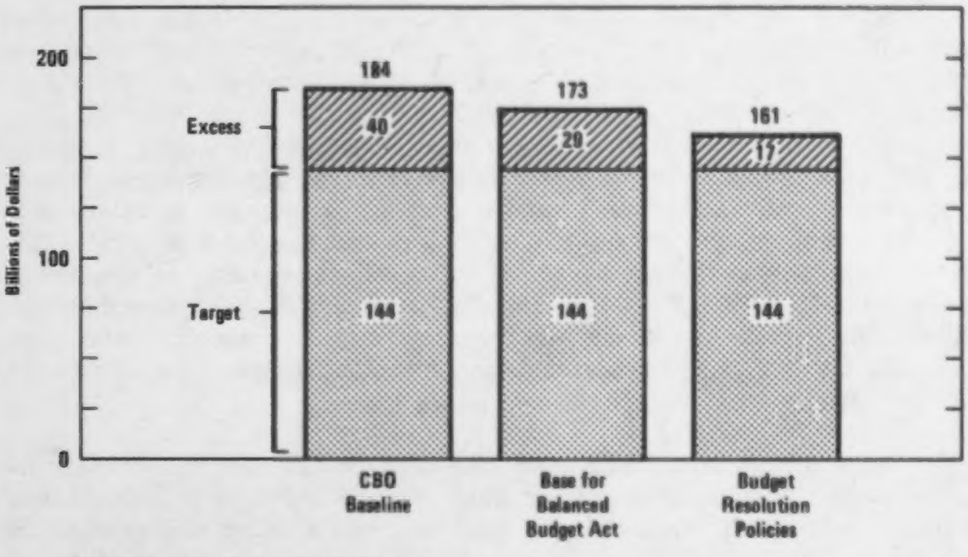
Summary Figure 1.

1987 Deficit Projections Under Different Policy Assumptions[a]



SOURCE: Congressional Budget Office.

[a] Includes Social Security, which is off-budget.

## RECENT ECONOMIC DEVELOPMENTS

In the first half of 1986, the economy grew at a rate significantly lower than most forecasters, including CBO, had projected last winter. Real economic growth eased down to 2¼ percent from the 3.1 percent recorded in the preceding six months. Inflation was also much lower than expected: as measured by the GNP deflator, inflation fell to about 2.3 percent (at an annual rate), while at the consumer level it was about zero.

The main reason for the substantial reduction in the rate of inflation was a precipitous drop in crude oil prices of some 60 percent since the end of last year--a much sharper decline than most analysts had anticipated. Although lower oil prices will clearly benefit the economy in the long run, the drop devastated the U.S. petroleum industry, so that its immediate effect on overall economic growth--and on employment--has to be adverse.

The decline in petroleum prices was not the only development in the first half of the year that bodes well for future economic growth. The dollar continued to decline against the currencies of other major industrial nations, and interest rates eased further as prospects for lower future deficits improved and the Federal Reserve continued to follow an accommodating monetary policy. These factors, together with the anticipation of continuing low inflation and of rising corporate profits, propelled the stock market to record highs by midyear and thus added hundreds of billions of dollars to household wealth.

Such favorable financial developments had led most forecasters to project a resumption of more rapid economic growth by mid-1986. But as of midyear the economy generally remained weak, and there are as yet very few signs of any pickup getting under way. The reasons for this apparent lack of response of aggregate output to improved financial conditions are not well understood and are subject to divergent interpretations by analysts. The most likely answer, even though not accepted by all, is that the economic environment has changed in such a way as to make the time lags between a price stimulus and an output response in some sectors longer than had been expected.

The weakness in 1986 has been concentrated in the manufacturing sector. Industrial production declined in the first half of 1986--at a 1.2 percent annual rate--in sharp contrast to its already sluggish growth rate of 2.2 percent in 1985. The rate of capacity utilization fell. Manufacturing employment also fell, but this was offset by strong employment growth in the service sector. Total payroll employment rose somewhat, but a rapid rise in the labor force pushed the unemployment rate, perhaps only temporarily, from 7.0 percent at the beginning of the year to 7.2 percent in the second quarter. The decline in industrial production resulted in part from the collapse of oil drilling. But foreign import penetration and export competition also continued to depress manufacturing output.

The rate of inflation in the first half of the year was exceptionally low (see Summary Table 1). The effect of sharply falling petroleum prices on the general price level was rapid and strong, while the falling dollar has so

SUMMARY TABLE 1. RECENT ECONOMIC INDICATORS

| | | | 1985 | | 1986 | |
|---|---|---|---|---|---|---|
| | 1984 | 1985 | III | IV | I | II |
| Real GNP (percent change) | 6.4 | 2.7 | 4.1 | 2.1 | 3.8 | 1.1 |
| Real final sales to domestic purchasers | 6.3 | 4.8 | 6.6 | 4.7 | -1.8 | 5.5 |
| Personal consumption expenditures | 4.7 | 3.5 | 5.3 | 1.7 | 3.6 | 5.9 |
| Business fixed investment | -16.9 | 9.3 | 0.1 | 12.5 | -15.1 | -2.6 |
| Residential investment | 14.3 | 3.9 | 11.7 | 3.4 | 11.0 | 15.4 |
| Government purchases | 4.0 | 6.8 | 13.9 | 10.0 | -12.3 | 7.0 |
| Inventory change (billions of 1982 dollars) | 59.2 | 9.0 | 0.7 | -5.2 | 39.9 | 19.6 |
| Net exports (billions of 1982 dollars) | -83.6 | -108.2 | -113.8 | -132.0 | -125.9 | -146.3 |
| Industrial Production (percent change) | 11.5 | 2.2 | 1.9 | 1.9 | 0.5 | -3.0 |
| Civilian Unemployment Rate | -7.5 | 7.2 | 7.2 | 7.0 | 7.1 | 7.2 |
| Consumer Price Index, Urban Consumers (percent change) | -4.3 | 3.5 | 2.6 | 4.3 | 1.5 | -1.7 |
| Three-Month Treasury Bill Rate | 9.5 | 7.5 | 7.1 | 7.2 | 6.9 | 6.1 |
| Corporate Bond Rate | 12.7 | 11.4 | 10.3 | 9.8 | 8.6 | 7.6 |

SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor; Federal Reserve Board.

far had relatively limited upward impact on import prices and therefore on the general price level. Food price increases remained moderate. On the other hand, prices of services continued to rise at about a 5 percent rate, and prices of goods that are relatively immune to foreign competition also continued to move up. As a result, if food and energy are excluded from the price measure, the rate of consumer price inflation has remained fixed at around 4 percent.

Economic sluggishness, together with an ample provision of liquidity by the Federal Reserve, contributed to a further easing of interest rates. They fell across the entire spectrum of maturities from short-term to long-term, reaching their lowest levels of this decade.

The lack of improvement in the U.S. foreign trade position, and a slight pickup of economic growth abroad in the second quarter, have been the main causes of the continued depreciation of the dollar. The dollar depreciated mainly against the currencies of Japan and Western Europe, while against the currencies of other U.S. major trading partners its value remained essentially unchanged.

The increase in aggregate demand in the first half of 1986 was concentrated in consumer spending and residential housing. Business inventories also rose. Despite lower interest rates, however, business fixed investment actually declined. Government purchases of goods and services also fell. Finally, net exports failed to rise from their record low level of the last half of 1985.

## THE CBO ECONOMIC PROJECTION

CBO's economic projection used for making budget estimates consists of two parts: a short-run forecast of economic conditions through 1987 that is contingent on specific fiscal and monetary policy assumptions; and a medium-term projection through 1991 that is based on historical trends in economic growth.

### The Forecast for 1986-1987

The short-run forecast shown in Summary Table 2 is contingent on the following assumptions:

- o Federal tax and spending policies are assumed to satisfy the deficit reduction requirement of the Balanced Budget Act;

- The Federal Reserve is assumed to be following a policy that would allow M2 to grow at approximately the midpoint of its announced target range, provided that M2 velocity growth follows past trends;
- The world price of oil is assumed to remain close to $12 per barrel through the end of 1987; and
- The exchange rate (as measured by the Federal Reserve Board index) is assumed to continue to decline, though at a much lower rate than in the past year, reaching by the end of 1987 a level about 18 percent below its level at the end of 1985.

Given these assumptions, CBO forecasts that real GNP will grow 2.9 percent over the four quarters of 1986 and at a somewhat more rapid rate, 3.5 percent, over the four quarters of next year. The unemployment rate will average 7.0 percent in 1986 and fall to 6.7 percent next year. Inflation, as measured by the Consumer Price Index, is projected to be very low--below 1½ percent in 1986--but to rise to around 4 percent in 1987, largely because of higher import prices induced by a depreciating dollar. The GNP

SUMMARY TABLE 2. THE CBO FORECAST FOR 1986 AND 1987 (In percents)

| Economic Variable | Actual 1984 | Actual 1985 | Forecast 1986 | Forecast 1987 |
|---|---|---|---|---|
| **Fourth Quarter to Fourth Quarter** | | | | |
| Nominal GNP | 8.5 | 6.3 | 5.3 | 7.5 |
| Real GNP | 4.6 | 2.9 | 2.9 | 3.5 |
| GNP Implicit Price Deflator | 3.6 | 3.3 | 2.4 | 3.9 |
| CPI-W | 3.3 | 3.2 | 1.2 | 4.0 |
| **Calendar-Year Averages** | | | | |
| Civilian Unemployment Rate | 7.5 | 7.2 | 7.0 | 6.7 |
| Three-Month T-Bill Rate | 9.5 | 7.5 | 6.2 | 6.4 |
| Ten-Year Government Bond Rate | 12.4 | 10.6 | 7.7 | 7.9 |

deflator--a measure of inflation that excludes imported goods--will show a smaller increase in inflation, from about 2.4 percent in 1986 to 3.9 percent in 1987. Interest rates, having fallen substantially in the first half of 1986, are expected to rise moderately throughout the forecasting period in response to more vigorous economic activity.

## Uncertainties in the Forecast

Every economic forecast is subject to a number of uncertainties. Right now, forecasting is particularly fraught with risks. Some fundamental uncertainties are:

- The effects on the economy of the restrictive shift in fiscal policy mandated by the Balanced Budget Act;
- The effects of the tax reform legislation now under consideration, which, if enacted, would change dramatically the incentives for such economic activities as saving, work, business investment, and homeownership.

The short-run impacts of such large changes in fiscal policy and the tax structure are a subject of controversy among economists. CBO's forecast assumes that the short-run contractionary impact of changing fiscal policy will be quickly offset by an improved trade balance and by lower interest rates than would otherwise prevail. If these offsetting forces occur more slowly than expected, an increase in economic growth may be delayed.

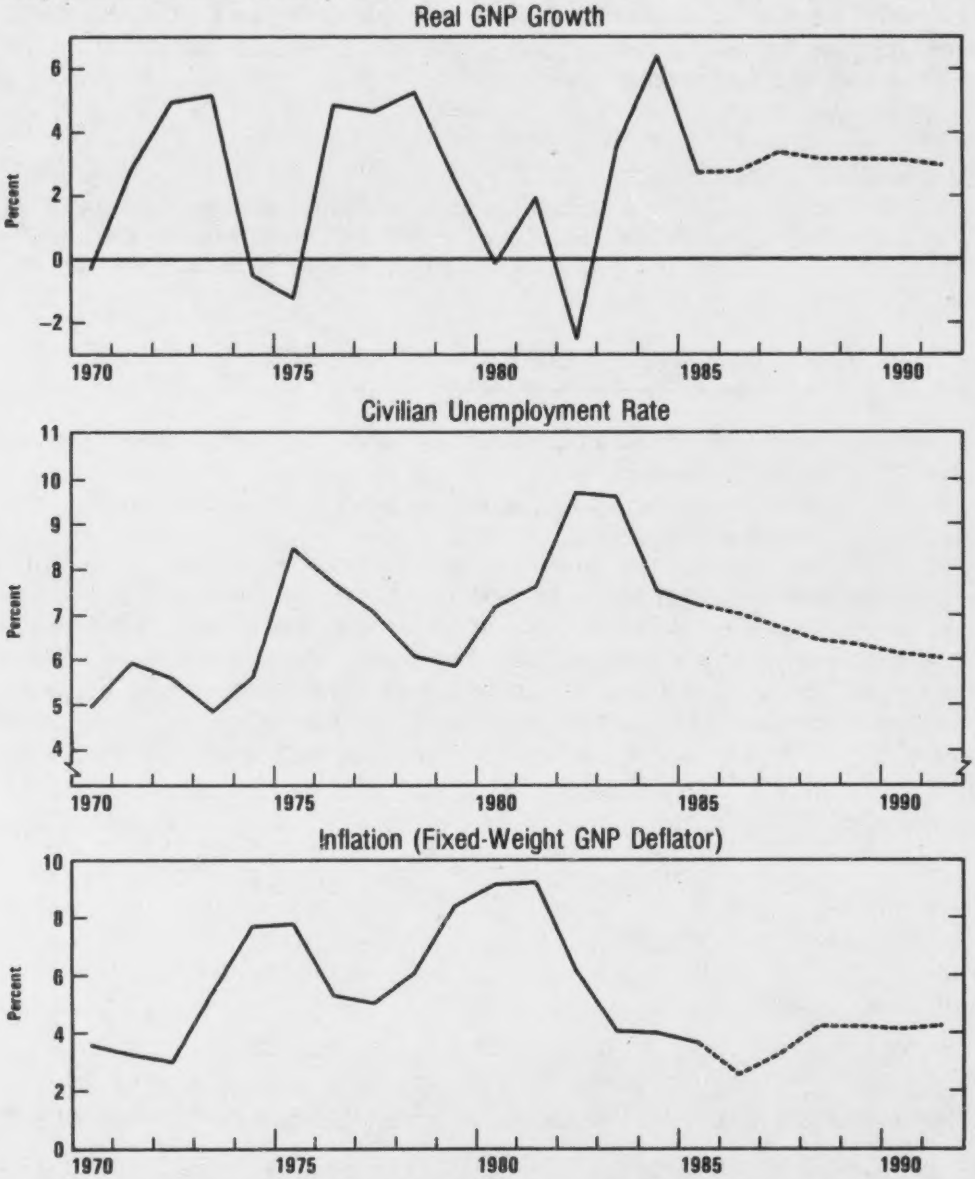
CBO's forecast is also based on the existing tax law. It is likely, however, that some private plans already reflect broad outlines of the main provisions of any new tax bill, and CBO's forecast takes into account indications of these private plans, such as information from various surveys of investment intentions, as well as more indirect indicators such as the behavior of the capital and commodity markets.

Beyond these uncertainties, and the continuing mystery of the future course of oil prices, the volatility in commodity, money, and foreign exchange markets makes this a particularly difficult time to try to forecast.

## Economic Projections for 1988-1991

CBO's medium-term projections for the years 1988 through 1991, depicted in Summary Figure 2, are constructed by using certain rules of thumb based on historical experience. Real gross domestic product (GDP) is assumed to

Summary Figure 2.
Major Economic Assumptions



Real GNP Growth

Civilian Unemployment Rate

Inflation (Fixed-Weight GNP Deflator)

SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor; Federal Reserve Board.

grow at an average rate of 3.2 percent in the 1988-1991 period--the same as its average in the period 1948 to 1985. This path for real GDP, in conjunction with an estimated relationship between real GNP growth and the unemployment rate, brings the latter to 6 percent at the beginning of 1991. GNP is expected to grow slightly more slowly than GDP. This slower growth is because net earnings from overseas assets, which account for almost all the difference between GNP and GDP, will decline. The inflation rate is assumed to remain constant at 4.1 percent. Interest rates are assumed to decline by 1991 to levels that approximate historical averages for both the real short rate and the spread between short and long rates (see Summary Figure 2).

## THE BUDGET OUTLOOK

Under CBO's economic assumptions and current budgetary policies, the federal government baseline budget deficit is projected to fall from $224 billion in the current fiscal year to $184 billion in 1987, $150 billion in 1988, $127 billion in 1989, and $69 billion by 1991. Under the same economic assumptions but incorporating the policies of the Congressional budget resolution, the deficit would be $161 billion in 1987, $118 billion in 1988, and $84 billion in 1989. The baseline projections substantially exceed the targets established in the Balanced Budget Act, as shown in Summary Figure 3. The budget resolution would come much closer to the targets in 1987 and 1989 and be within the $10 billion tolerance range in 1988.

The Supreme Court decided on July 7 that the automatic deficit reduction provisions of the Balanced Budget Act are unconstitutional. Under the fallback provisions of the law, however, the across-the-board cancellation of budgetary resources remains an option for Congressional consideration. As the law now stands, on August 20 the Congressional Budget Office and the Office of Management and Budget (OMB) will report to the Congress on an estimate of the deficit for fiscal year 1987. If the average of the CBO and OMB deficit estimates exceeds $154 billion, the Congress will be required to vote on a joint resolution that would reduce the deficit to $144 billion by means of across-the-board spending cuts. The Congress may also reach the target through an alternative package of deficit reduction measures.

Under the budgetary assumptions specified in the Balanced Budget Act (which differ from those of the CBO baseline), CBO currently estimates a 1987 base deficit of $173 billion. A deficit of this size would require across-the-board reductions of 8.2 percent in defense programs and 11.5 percent in nondefense programs in order to achieve the $144 billion deficit target. The actual size of the cuts required will, of course, depend on the average of the CBO and OMB deficit estimates, which will not be known until August 20.

SUMMARY TABLE 3. BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

| | Actual 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|
| **Budget Projections (By fiscal year, in billions of dollars) a/** | | | | | | | |
| Baseline Projections | | | | | | | |
| Revenues | 734 | 767 | 828 | 915 | 987 | 1,067 | 1,148 |
| Outlays | 946 | 991 | 1,012 | 1,065 | 1,113 | 1,162 | 1,217 |
| Deficit | 212 | 224 | 184 | 150 | 127 | 96 | 69 |
| Deficit Targets | n.a. | 172 | 144 | 108 | 72 | 36 | 0 |
| Baseline Less Targets | n.a. | 52 | 40 | 42 | 55 | 60 | 69 |
| Budget Resolution CBO Estimate | n.a. | n.a. | 161 | 118 | 84 | n.a. | n.a. |
| **Economic Assumptions (By calendar year)** | | | | | | | |
| Nominal GNP, percent change | 6.2 | 5.5 | 6.8 | 7.4 | 7.3 | 7.3 | 7.3 |
| Real GNP, percent change | 2.7 | 2.8 | 3.4 | 3.2 | 3.2 | 3.1 | 3.0 |
| CPI-W, percent change | 3.5 | 1.6 | 3.3 | 4.1 | 4.1 | 4.1 | 4.1 |
| Civilian Unemployment Rate | 7.2 | 7.0 | 6.7 | 6.4 | 6.3 | 6.1 | 6.0 |
| Three-Month Treasury Bill Rate | 7.5 | 6.2 | 6.4 | 6.3 | 6.0 | 5.7 | 5.3 |

SOURCE: Congressional Budget Office.
NOTE: n.a. = not applicable.

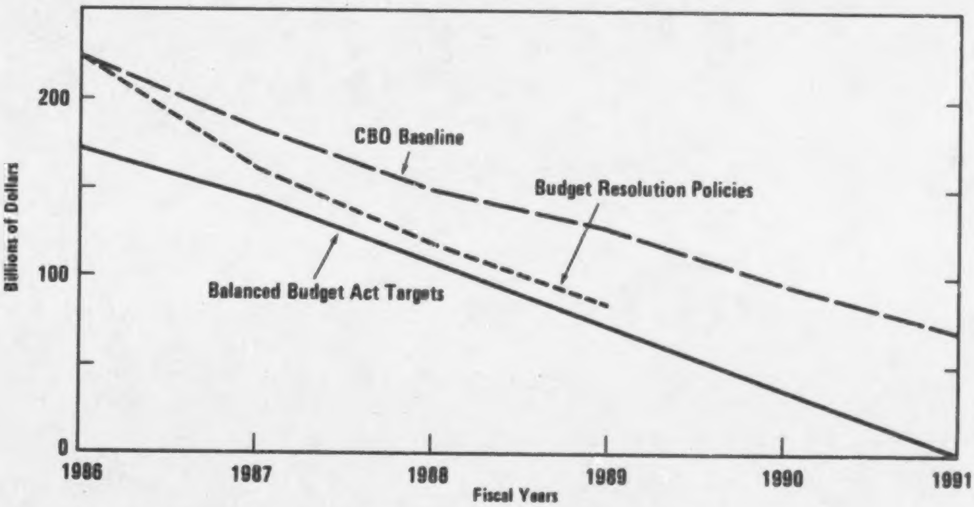
a. Includes Social Security, which is off-budget.

The immediate outlook for the deficit has worsened somewhat since February, when CBO projected baseline deficits of $208 billion for 1986 and $181 billion for 1987. The outlook for the 1988-1991 period, however, has become slightly brighter. This pattern of budgetary changes mirrors the revisions in the underlying economic assumptions. Lower real growth and inflation have reduced taxable incomes and significantly depleted expected revenues in 1986 and 1987. In later years, taxable incomes--especially corporate profits--are now projected to grow more rapidly, as should revenues. Baseline revenues grow from 18.7 percent of GNP in 1987 to 19.5 percent of GNP by 1991. By comparison, under CBO's February economic assumptions, taxes would represent 18.8 percent of GNP in 1987 but only 19.0 percent of GNP in 1991. Taken by itself, this increase in the projected ratio of taxes to GNP adds roughly $30 billion to revenues by 1991. All in all, changes in the economic assumptions add $7 billion to the estimated 1986 deficit and $3 billion to the projected baseline deficit for 1987 but reduce the 1991 deficit projection by $35 billion.

Aside from changes in the economic assumptions, other recent developments have had little effect on the baseline deficit projections. The

Summary Figure 3.

Baseline, Budget Resolution, and Target Deficits[a]



SOURCE: Congressional Budget Office.

[a] Includes Social Security, which is off-budget.

enactment of new legislation, primarily the Consolidated Omnibus Budget Reconciliation Act of 1985, has reduced the deficit by $5 billion in 1986 and an average of $13 billion per year in the 1987-1991 period. Technical reestimates, however, have tended to increase the deficit. Higher spending for national defense, farm price supports, deposit insurance, and other federal programs and downward adjustments to revenue have added $14 billion to the 1986 deficit and an average of $12 billion annually thereafter. The net effect of legislative cuts and upward technical reestimates is to increase the 1986 deficit by $9 billion and to reduce the baseline deficit by about $1 billion per year in later years.

The same factors that have affected the baseline estimates also have caused the budget resolution deficits to change, although by differing amounts. As adopted by the Congress on June 26, the resolution showed deficits of $143 billion in 1987, $116 billion in 1988, and $78 billion in 1989. Under CBO's updated economic and technical estimating assumptions, however, budget resolution policies would achieve deficits of $161 billion in 1987, $118 billion in 1988, and $84 billion in 1989. While not quite meeting the Balanced Budget Act targets, these deficits represent reductions of $23 billion, $32 billion, and $43 billion, respectively, in the 1987-1989 period compared with the CBO baseline.

## CHAPTER I

# THE ECONOMIC OUTLOOK

The Congressional Budget Office (CBO) projects that economic growth will pick up in the year ahead, with a steady decline in unemployment. Inflation rates are expected to increase as oil prices stabilize and the effects of rising import prices begin to spread through the economy. The prospects of lower federal deficits have paved the way for declines in the value of the dollar and in interest rates. Both of these forces should trigger more rapid growth in the near future, though at midyear economic conditions remained generally weak and there were few signs that the much awaited expansion had begun.

In the first half of 1986, the economy grew more slowly than CBO had projected last winter. Inflation was much lower than expected. The reasons why the outcome differed from the forecast are far from clear. One factor appears to have been business uncertainty over federal tax and spending policies. Another was the drop in oil prices, which fell by nearly 60 percent from their level in December. 1/

In the areas of taxes and spending, the first six months of 1986 marked two important developments: the Congress debated a major tax reform bill, and the first spending cuts under the Balanced Budget and Emergency Deficit Control Act of 1985 (the Balanced Budget Act) took effect. While tax reform and deficit reduction are both expected to help the economy in the long term, both have created uncertainty that may have contributed to increased volatility and possibly to a temporary slowdown.

The sharp decline in oil prices, which was much larger than most analysts had anticipated, had mixed effects. In the 1970s, sharp rises in oil prices seemed to increase inflation and slow the economy simultaneously. In 1986, on the other hand, the reduction in oil prices brought inflation down, but the expected stimulus to growth was slow to develop. Moreover, the price drop had a devastating effect on the U.S. oil industry.

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1. CBO had assumed an 18 percent decline in the refiners acquisition cost from December 1985 to July 1986.

## THE ECONOMIC FORECAST AND MEDIUM-TERM PROJECTIONS

The CBO economic projections consist of two parts: a short-run forecast of economic conditions through 1987 that is conditional on specific policy assumptions, and a medium-term projection based on historical average growth rates (see Figure I-1).

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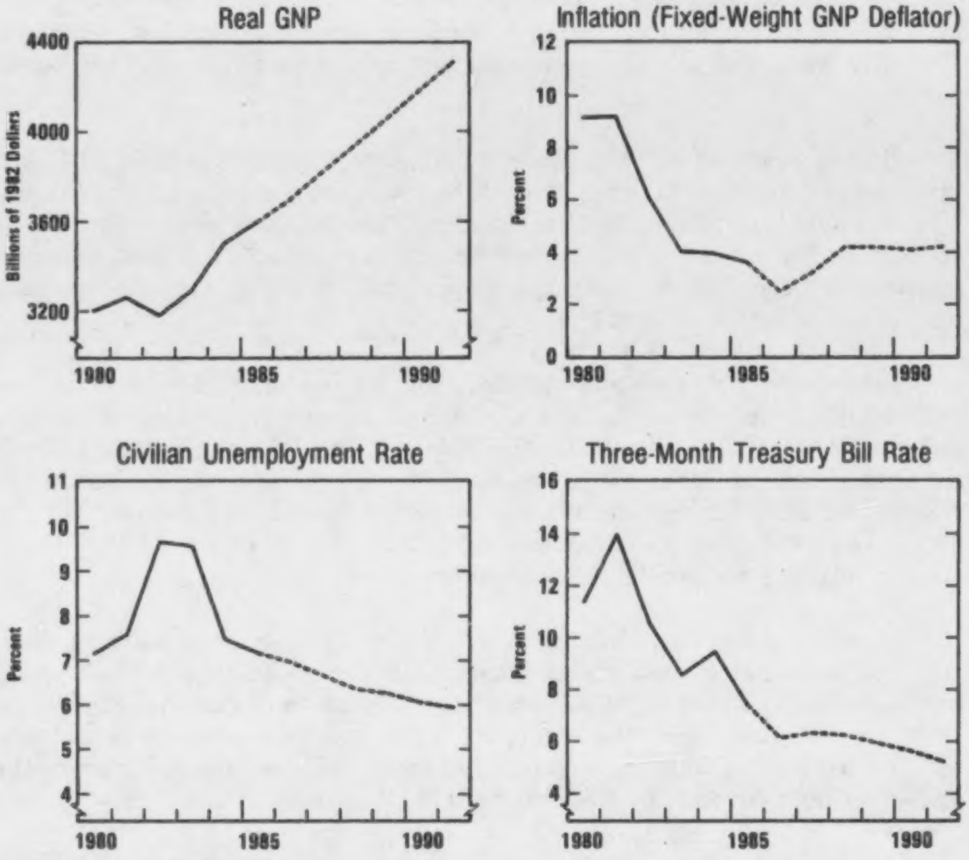
Figure I-1.
Economic Assumptions



SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Bureau of Labor Statistics, U.S. Department of Labor; Federal Reserve Board.

## The Short-Run Forecast

The short-run forecast is based on the following assumptions:

- Federal tax and spending policies are assumed to satisfy the deficit requirements of the Balanced Budget Act;
- The Federal Reserve Board is assumed to follow a policy that would allow M2 to grow at approximately the midpoint of its announced target range, provided that M2 velocity growth follows its past trends;
- The world price of oil is assumed to remain close to $12 per barrel through the end of 1987; and
- The exchange rate (the Federal Reserve Board index) is assumed to continue to decline, though at a much lower rate than over the past year, reaching by the end of 1987 a level about 18 percent below its average at the end of 1985.

TABLE I-1. THE CBO FORECAST FOR 1986 AND 1987

| | Actual | | Forecast | |
|---|---|---|---|---|
| | 1984 | 1985 | 1986 | 1987 |
| **Fourth Quarter to Fourth Quarter (percent change)** | | | | |
| Nominal GNP | 8.5 | 6.3 | 5.3 | 7.5 |
| Real GNP | 4.6 | 2.9 | 2.9 | 3.5 |
| Implicit GNP Deflator | 3.6 | 3.3 | 2.4 | 3.9 |
| CPI-W a/ | 3.3 | 3.2 | 1.2 | 4.0 |
| **Calendar-Year Averages (percent)** | | | | |
| Civilian Unemployment Rate | 7.5 | 7.2 | 7.0 | 6.7 |
| Three-Month Treasury Bill Rate | 9.5 | 7.5 | 6.2 | 6.4 |
| Ten-Year Government Bond Rate | 12.4 | 10.6 | 7.7 | 7.9 |

a. Consumer Price Index for urban wage earners and clerical workers.

Given these assumptions, real GNP in the fourth quarter of 1986 is projected to be 2.9 percent higher than in the fourth quarter of 1985, and to grow somewhat faster, 3.5 percent, in 1987 (see Table I-1). As a result of lower oil prices, inflation at the consumer level will be very low (below 1½ percent) during 1986, but is expected to accelerate to the 4 percent range during 1987 as oil prices stabilize and as higher import costs resulting from the lower dollar begin to affect prices. The unemployment rate is expected to remain at 7 percent on average this year and to fall to 6.7 percent next year. Although the 3-month Treasury bill rate and the 10-year Treasury bond rate are expected to rise slightly in 1987 from current levels, the increase is expected to be less than the rise in inflation. As a result, real interest rates are expected to decline.

Household spending should be supported in the year ahead by three factors: the decline in interest rates, low inflation, and the huge rise in the value of financial assets over the past year. The interest-rate decline and increased demand are also expected to generate an eventual resumption in the growth of producers' durable equipment investment. In contrast, real government purchases of goods and services are expected to be reduced under the constraints of the Balanced Budget Act.

In sum, CBO expects the economy to strengthen in the year ahead. The short-run adverse effect of the fall in oil prices on oil field activity should constitute a smaller drag in coming months; interest rates have remained low relative to their 1985 levels; and there are signs that the deterioration in net exports is coming to an end. Forecasts made at this time, however, are subject to an unusual number of uncertainties. Recent months have included abnormal volatility in commodity, money, and foreign exchange markets. This volatility presents difficulties to the forecaster in projecting the near-term outlook for oil prices, prices of agricultural products, interest rates, and exchange rates--all of them crucial ingredients of the forecast. In addition, the volatility is itself a reflection of more fundamental uncertainties that affect both financial markets and the rest of the economy. These fundamental uncertainties include:

- The effects on the economy of the restrictive shift in fiscal policy mandated by the Balanced Budget Act;

- The effects of the tax reform now under consideration, which could change the composition and sources of federal receipts and alter incentives for economic activities such as saving, working, investing, and owning homes;

- The actions of the OPEC oil producers in the face of current low prices;

- The speed with which the decline in the value of the dollar works to improve the real trade balance;
- The risk to U.S. exports if economic growth abroad remains weak, thereby offsetting the beneficial effects of depreciation of the dollar; and
- The effect of relatively high household and business debt, which could cause a sudden retrenchment of spending.

There is much controversy about the short-run impact of the large tax-law changes now being negotiated in the Congress. CBO's forecast does not explicitly include these changes. It is likely, however, that private plans already reflect in broad outline the main provisions that will emerge, and CBO's forecast takes into account indications of private plans such as the various surveys of investment intentions, as well as more indirect indicators such as the reaction of money and commodity markets.

## Medium-Term Projections

CBO's revised medium-term projections for the years 1988 through 1991, presented in Table I-2, are constructed from historically based rules of thumb. Real gross domestic product (GDP) is assumed to grow over the period at a rate of about 3.2 percent, which was the average real GDP growth rate for the years 1948 through 1985. This path for real GDP, in conjunction with an estimated "Okun's Law" relationship between real gross national product (GNP) growth and unemployment, brings the unemployment rate down to 6 percent by the beginning of 1991. For the remainder of the projected period, real GNP is assumed to increase at a rate that keeps the unemployment rate at 6 percent. 2/ The still large current account deficit will reduce net U.S. holdings of foreign assets, and thus the flow of net income from abroad. GNP, which differs from GDP by the amount of these foreign earnings, is therefore expected to grow a bit more slowly than GDP. The inflation rate as measured by the GNP deflator is assumed to remain constant at a rate of 4.1 percent, which is very slightly below its long-term average in the years 1948 through 1985. Interest rates are assumed to decline to 1991 levels that will approximate historical averages for both the real short rate and the nominal spread between short and long rates.

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2. The rules of thumb used in these projections differ slightly from those used in the projections published in CBO's annual report last February. The February report used a different, and more complex, rule of thumb for projecting real GNP growth that was sensitive to the stage of the business cycle. The current, simpler rule, which applies the historical average GDP growth rate to the projections from 1988 to 1991, performs better in tracking historical growth patterns than the rule used last February.

TABLE I-2. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1988-1991

| Economic Variable | Actual | Forecast | | Projected | | | |
|---|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
| GNP (billions of current dollars) | 3,998 | 4,218 | 4,504 | 4,838 | 5,193 | 5,575 | 5,975 |
| Nominal GNP Growth (percent change) | 6.2 | 5.5 | 6.8 | 7.4 | 7.3 | 7.3 | 7.2 |
| Real GNP Growth (percent change) | 2.7 | 2.8 | 3.4 | 3.2 | 3.2 | 3.1 | 3.0 |
| Implicit GNP Deflator (percent change) | 3.3 | 2.7 | 3.3 | 4.1 | 4.1 | 4.1 | 4.1 |
| CPI-W (percent change) | 3.5 | 1.6 | 3.3 | 4.1 | 4.1 | 4.1 | 4.1 |
| Civilian Unemployment Rate (percent) | 7.2 | 7.0 | 6.7 | 6.4 | 6.3 | 6.1 | 6.0 |
| Three-Month Treasury Bill Rate (percent) | 7.5 | 6.2 | 6.4 | 6.3 | 6.0 | 5.7 | 5.3 |
| Ten-Year Government Bond Rate (percent) | 10.6 | 7.7 | 7.9 | 7.6 | 6.9 | 6.1 | 5.7 |
| Corporate Profits (percent of GNP) | 7.0 | 7.3 | 7.4 | 7.3 | 7.3 | 7.3 | 7.4 |
| Wage and Salary Disbursements (percent of GNP) | 49.2 | 49.3 | 49.4 | 49.4 | 49.5 | 49.6 | 49.6 |
| Other Taxable Income (percent of GNP) | 20.4 | 20.3 | 20.3 | 20.2 | 19.9 | 19.5 | 19.2 |

SOURCE: Congressional Budget Office.

TABLE I-3. MEDIUM-TERM ECONOMIC PROJECTIONS FOR FISCAL YEARS 1988-1991

| Economic Variable | Actual | Forecast | | Projected | | | |
|---|---|---|---|---|---|---|---|
| | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
| GNP (billions of current dollars) | 3,938 | 4,164 | 4,423 | 4,753 | 5,102 | 5,477 | 5,876 |
| Nominal GNP Growth (percent change) | 6.7 | 5.8 | 6.2 | 7.5 | 7.3 | 7.3 | 7.3 |
| Real GNP Growth (percent change) | 3.1 | 2.8 | 3.2 | 3.3 | 3.1 | 3.1 | 3.1 |
| Implicit GNP Deflator (percent change) | 3.4 | 2.9 | 2.9 | 4.1 | 4.1 | 4.1 | 4.1 |
| CPI-W (percent change) | 3.6 | 2.1 | 2.6 | 4.1 | 4.1 | 4.1 | 4.1 |
| Civilian Unemployment Rate (percent) | 7.3 | 7.1 | 6.8 | 6.4 | 6.3 | 6.1 | 6.0 |
| Three-Month Treasury Bill Rate (percent) | 7.9 | 6.5 | 6.3 | 6.3 | 6.2 | 5.8 | 5.4 |
| Ten-Year Government Bond Rate (percent) | 11.1 | 8.3 | 7.7 | 7.8 | 7.1 | 6.3 | 5.8 |
| Corporate Profits (percent of GNP) | 7.0 | 7.2 | 7.4 | 7.4 | 7.3 | 7.3 | 7.4 |
| Wage and Salary Disbursements (percent of GNP) | 49.1 | 49.2 | 49.3 | 49.4 | 49.5 | 49.6 | 49.6 |
| Other Taxable Income (percent of GNP) | 20.4 | 20.3 | 20.2 | 20.3 | 19.9 | 19.6 | 19.3 |

SOURCE: Congressional Budget Office.

The Tax Base. Projections of federal revenues depend in part on how wages, profits, and other incomes are assumed to behave (see Table I-2). Taxable wages should grow slightly faster relative to GNP during the next few years for two reasons:

- Many analysts believe that the rise in the dollar between 1980 and 1985 worked to hold down wages, especially in tradeable goods industries: the decline in the dollar and consequent projected improvement in net exports is expected to permit stronger wage growth; and

- The growth of nontaxable fringe benefits (pensions, health insurance contributions, and so forth) relative to wages appears to have stopped, and consequently taxable wages should grow as fast as compensation. 3/

Lower interest rates and a slowing of the growth of the federal debt will mean a relative decline in personal interest payments, a major component of other taxable income in Table I-2. Profits will tend to be held back by higher real wage growth, and by the increase in employers' contributions for social insurance slated for 1988, but will be increased by the reduction of interest expense and by reduced foreign competition as the dollar falls. On balance, the profit share in 1991 is expected to be somewhat above the rate expected for this year.

## RECENT ECONOMIC DEVELOPMENTS

Real GNP growth in the first half of 1986 was uneven but averaged only 2.4 percent, little changed from its sluggish 2.7 percent growth in 1985 (see Table I-4). Industrial production actually declined at a 1.2 percent annual rate in the first two quarters of this year, after rising 2.2 percent in 1985. The industrial capacity utilization rate reflected this weakness, registering below 79 percent in June compared with 80 percent for the fourth quarter of 1985. The overall unemployment rate rose slightly, primarily as a result of weakness in the goods-producing sectors, although employment growth remained strong in the service sector.

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3. One of the major sources of relative growth in fringe benefits, that of health care insurance, appears to have been checked in recent years. The growth in pension plan assets resulting from the stock market's rise has recently permitted employers to reduce contributions or to reorganize plans, in effect extracting their previous contributions. This practice may not continue. Nontaxable fringe benefits may also begin to grow again as a result of the increasing prevalence of 401K plans, which give employees the option of converting taxable wages into tax-deferred pension contributions. The expected growth of these plans, which is not incorporated in the economic projections, has been taken into account in computing revenue projections.

The decline in industrial production in the first half was partially a reflection of the collapse of petroleum drilling. But even if the mining sector is excluded, industrial production has not grown. Large trade deficits have continued to dampen the growth of manufacturing output. In contrast to the manufacturing and mining sectors, the construction and the service-producing sectors of the economy have been strong. As a result, in the first half of 1986, the growth rate of total payroll employment eased only slightly from the 3.3 percent rate of 1985.

The pace of growth from quarter to quarter has also been quite uneven. After increasing at a 3.8 percent rate in the first quarter of this year, real GNP grew at only a 1.1 percent rate in the second quarter. The components of GNP, however, behaved in ways that make it difficult to say whether the slowdown is an indication of continuing weakness. For example:

- Consumer spending rose at a 5.9 percent rate in the second quarter, a growth rate that is not likely to be sustained;

- Oil imports volume surged in the second quarter because of increased demands and because oil inventories had been drawn down sharply in the first quarter. This surge reduced net exports by about $16 billion (in 1982 dollars) in the second quarter. Although high levels of oil imports are expected to continue, another surge is not anticipated in the third quarter;

TABLE I-4. RECENT MEASURES OF AGGREGATE ECONOMIC ACTIVITY (Percent change at annual rates)

| | | | 1985 | | | | 1986 | |
|---|---|---|---|---|---|---|---|---|
| | 1984 | 1985 | I | II | III | IV | I | II |
| Real GNP | 6.4 | 2.7 | 3.1 | 2.3 | 4.1 | 2.1 | 3.8 | 1.1 |
| Real Final Sales a/ | 4.4 | 3.5 | 4.1 | 3.2 | 5.0 | 0.4 | 1.6 | 4.0 |
| Industrial Production | 11.5 | 2.2 | 2.3 | 1.3 | 1.9 | 1.9 | 0.5 | -3.0 |
| Industrial Production (Less Mining) | 11.9 | 2.6 | 1.6 | 1.5 | 2.8 | 2.4 | 1.4 | -1.5 |
| Payroll Employment | 4.8 | 3.3 | 2.8 | 3.0 | 2.5 | 3.2 | 3.0 | 1.8 |
| Unemployment Rate | 7.5 | 7.2 | 7.3 | 7.3 | 7.2 | 7.0 | 7.1 | 7.2 |

a. Excluding Commodity Credit Corporation (CCC) purchases.

- Real government purchases of goods and services (excluding Commodity Credit Corporation purchases) grew by 13 percent, led by a 16 percent jump in defense, and a 51 percent jump in state and local structures. It is unlikely, however, that these growth rates will continue;

- Auto production was cut back sharply in the second quarter to reduce excessive inventories (thereby reducing GNP growth by 0.7 percentage point). Current production schedules (seasonally adjusted) call for a substantial increase in auto production this quarter from the second-quarter levels.

## Labor Markets

Labor markets continued to be soft in the first half of the year, and the unemployment rate for the civilian labor force fluctuated narrowly about 7 percent. Wage gains were very moderate, and productivity growth continued to be disappointing.

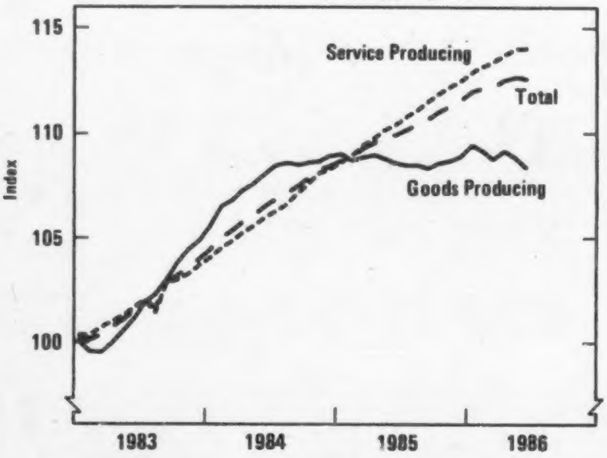
Employment. The demand for labor grew somewhat more slowly during the first half of the year than in the second half of 1985. Payroll employment, after accounting for striking workers, grew an average of approximately 140,000 jobs per month from January to June, compared with 270,000 per month in the previous half-year. These aggregate figures masked major disparities among industries. Manufacturing payrolls fell by roughly 110,000 from January to June, after adjusting for strikes. Most of that decline was concentrated in durable goods industries and the sharpest employment declines came in mining, specifically in oil and gas extraction (see Figure I-2). Payrolls in oil and gas extraction in June were down about 113,000 from the level in January--a decline of roughly 20 percent. (That industry has lost nearly 320,000 workers since its employment peak in March 1982.) In contrast to the loss of jobs in durable goods manufacturing and mining, employment continued to grow strongly during the first half of the year in construction and in most of the service-producing industries.

Labor Force and Unemployment. If employment growth in the first half was relatively sluggish, growth in the labor force was not. The civilian labor force grew by 1.3 million people from January to June and by 3.1 million from June 1985 to June 1986, with women accounting for the bulk of this employment growth. In that period, the number of adult women in the labor force grew by about 1.6 million.

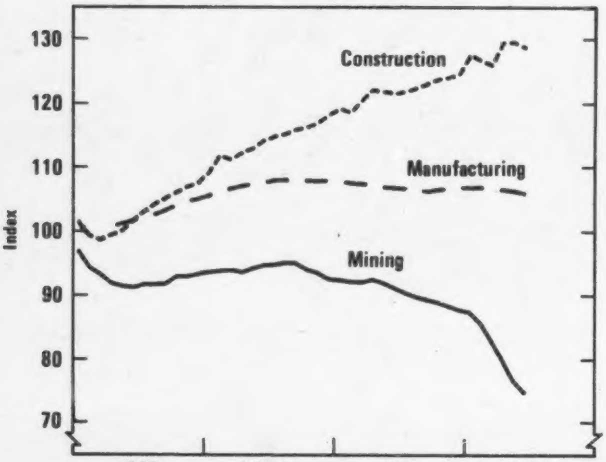
Unemployment in the civilian labor force edged up from an average of 7.0 percent in January-February to 7.2 percent in May-June--thus reversing the declines in unemployment during the second half of 1985 (see Figure I-3). As this report was going to press, the rate edged down to 6.9 percent in July. In June, the unemployment rate for adult men was only slightly below that of adult women--6.2 percent versus 6.4 percent. The rate for

Figure I-2.
Payroll Employment

Total and Major Aggregates



Goods-Producing Industries



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

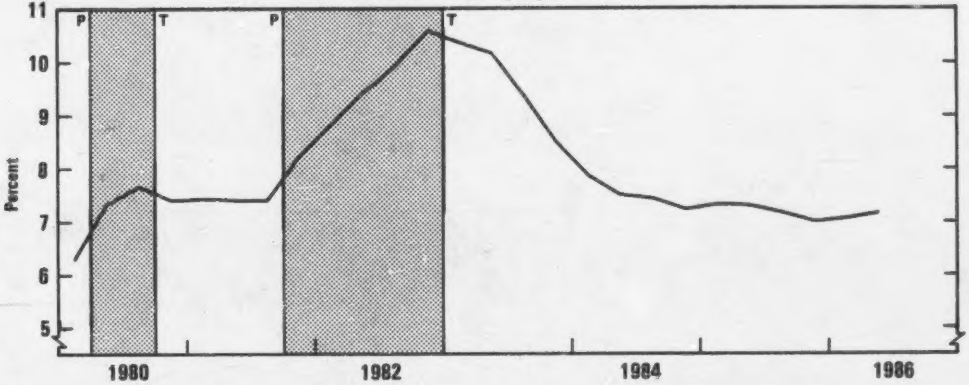
NOTE: All employment series are indexed, November 1982 = 100.

adult males was up about four-tenths of a percent from January-February to May-June, compared with a rise of about one-tenth of a percent for adult women--reflecting the weakness in the goods-producing sector. The teenage unemployment rate was about 19 percent in May-June, slightly higher than at the beginning of the year. The unemployment rate for black workers remained about 2½ times higher than that for white workers (in June, 15.1 percent compared with 6.1 percent).

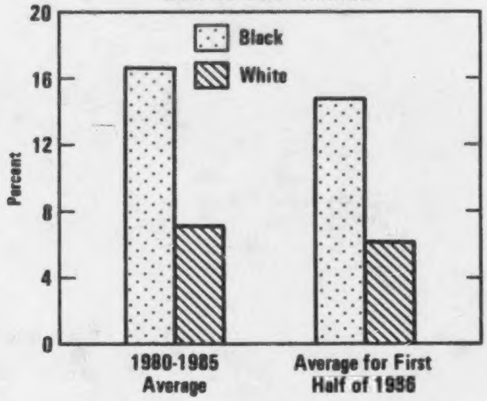
The collapse of the oil industry was reflected in very high unemployment in the mining industry--17.6 percent in June compared with

Figure I-3.
Civilian Unemployment Rates

Overall Unemployment Rate



Unemployment Rates for Blacks and Whites



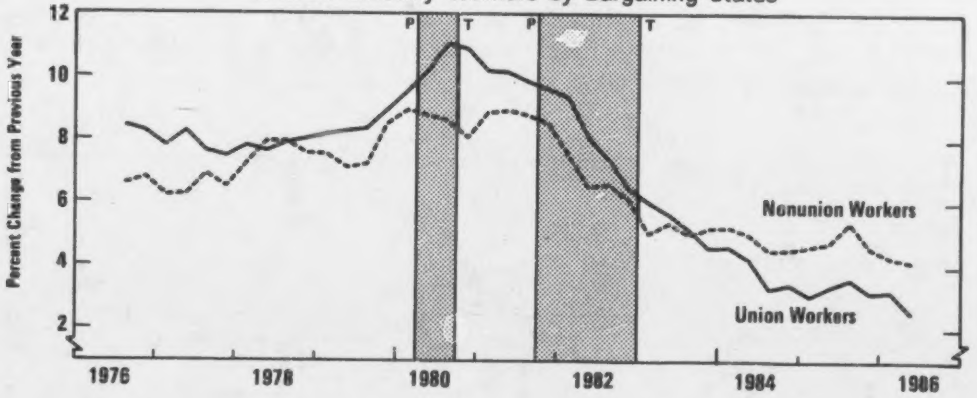
SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

10.9 percent a year ago. The effect was concentrated in energy-producing states such as Texas, which had an unemployment rate of 10.5 percent in June compared with 7.1 percent a year ago. By contrast, unemployment in some areas of the country, particularly in the East, was quite low. For instance, Massachusetts' unemployment rate in June was 3.6 percent.

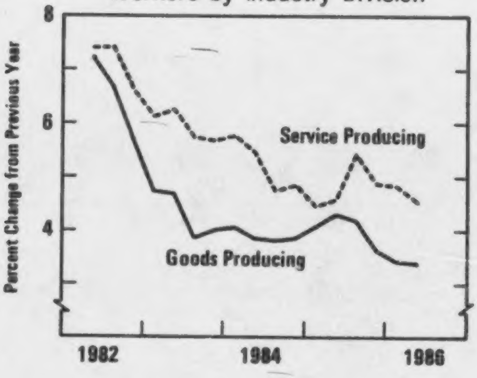
Wages. Recent data suggest that money wage increases have moderated further. The index of average hourly earnings in the second quarter of this year was only 2.5 percent above the level of a year ago. The employment cost index, a more comprehensive measure, showed somewhat larger gains, though these were only moderate (see Figure I-4). In the second quarter,

Figure I-4.
Employment Cost Index, Wages and Salaries

Private Industry Workers by Bargaining Status



Workers by Industry Division



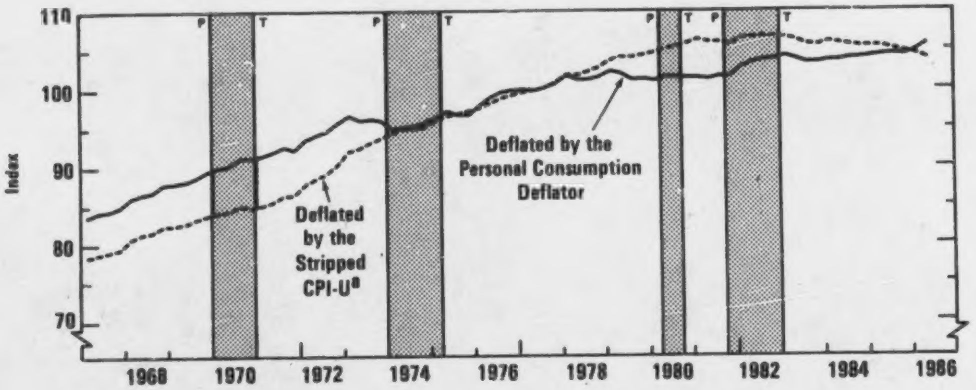
SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

the cost index for total compensation was up 4.0 percent from the level of a year ago. Wage increases were running higher for nonunion than for union workers and higher in service-producing industries than in goods-producing industries. But there was no acceleration in wages, even in nonunion and service industries. Before 1985, wage and salary increases understated cost pressures because fringe benefits were rising more rapidly than wages and salaries. Beginning in 1985, however, fringe benefits have been rising at roughly the same rate as wages and salaries.

Real wages--nominal wages adjusted for changes in the cost of living--have grown unusually slowly during most of the current expansion. In fact, were it not for the weakness of food and oil prices since 1983, real compensation per hour in the nonfarm business sector would have fallen since the last recession trough--see Figure I-5. With the recent fall in oil prices, however, the Consumer Price Index has actually declined moderately, which has helped to boost real wages. This improvement in real wages has in turn helped to spur strong consumer spending.

Unions have been settling for unusually low wage increases in contract negotiations. Major private union settlements in the first half of 1986 provided increases of 1.2 percent in the first year and 1.9 percent annually

Figure I-5.
Real Compensation Per Man-Hour



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, Department of Labor; Bureau of Economic Analysis, U.S Department of Commerce.

[a] CPI-U less food, energy, and used cars.

over the life of the contract (not including automatic cost of living adjustments). The last time the same parties bargained (generally two to three years ago), average wage adjustments were 2.5 percent in the first year and 3.1 percent annually over the contract life.

Several factors have been instrumental in bringing about much lower wage increases: continued slack in labor markets, slower increases in the cost of living, more intense competitive pressures in markets for tradeable goods, and intensified competitive pressures in recently deregulated industries. Most forecasters foresee a mild acceleration in wages during the next two years, primarily because labor markets are expected to tighten and the moderating effect of commodity prices will be largely temporary. Moreover, the projected turnaround in the U.S. international competitive position could put an end to severe downward wage pressure in a number of manufacturing industries.

Productivity and Unit Labor Costs. Productivity growth in the nonfarm business sector has continued to be erratic on a quarter-to-quarter basis, and disappointing overall (see Figure I-6). Nonfarm business productivity increased only 0.5 percent in 1985. But in the manufacturing sector, available data suggest that productivity growth has been much more encouraging, in part because of increased foreign competition. 4/ This has been offset, however, by extremely poor performance in the nonmanufacturing (nonfarm) sector, the reasons for which are not well understood.

The combination of moderate wage growth and relatively flat productivity meant that unit labor costs grew at roughly a 2 percent to 4 percent rate in recent quarters (see Figure I-6). In manufacturing, cost pressures have been considerably lower than in the nonfarm business sector as a whole because of lower wage gains and higher productivity growth.

## Inflation Update

Prices have risen much less in the last half year than was anticipated for several reasons. The decline in the price of oil was unexpectedly large. The sharp drop in the value of the dollar has so far increased import prices less than had been expected. Food price increases have remained moderate. As a result, the Consumer Price Index fell for three months this spring, for the first time since 1954.

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4. Data on recent productivity trends in manufacturing and (nonfarm) nonmanufacturing are subject to wide margins of error.

Some prices have moved contrary to this general trend: if prices of food, energy, and used cars are excluded from the measure of price increase, the rate of consumer price inflation has remained stubbornly at around 4 percent (see Figure I-7). Prices of services in particular, which are not subject to foreign trade pressures as much as those of goods, have

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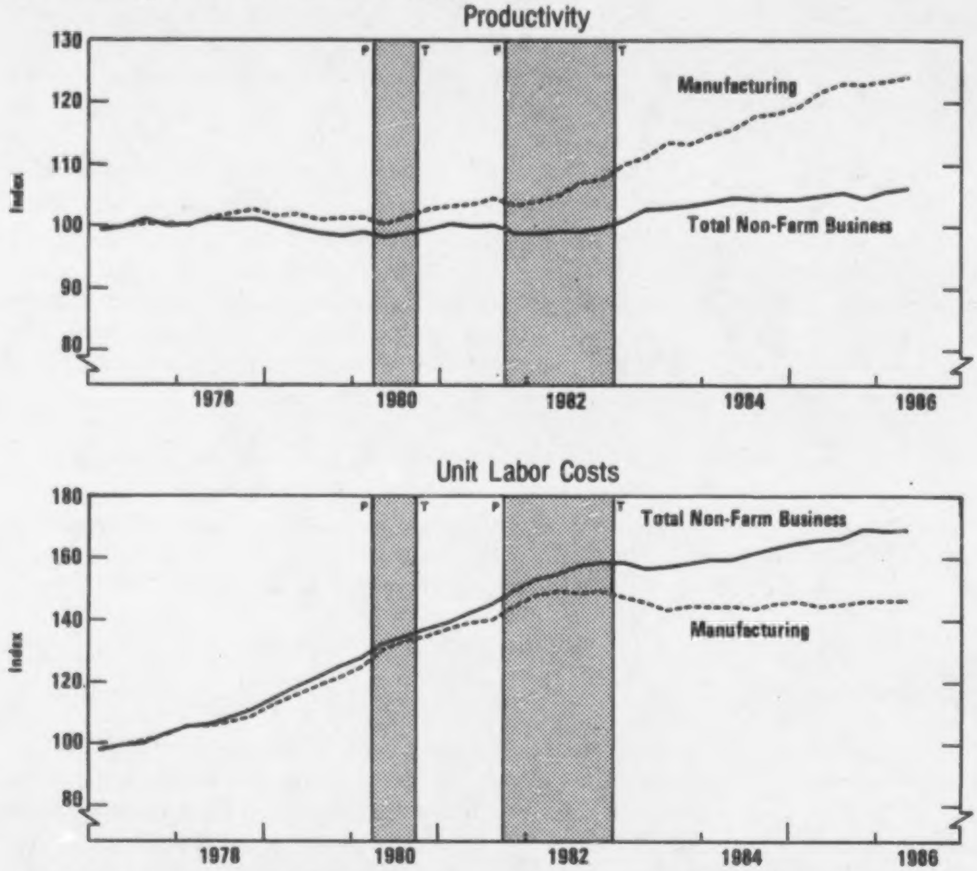
Figure I-6.

Productivity and Unit Labor Costs



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

TABLE I-5. INFLATION (Percent change, fourth quarter to fourth quarter, unless otherwise noted)

|  | 1982 | 1983 | 1984 | 1985 | 1986 a/ I | 1986 a/ II |
|---|---|---|---|---|---|---|
| Fixed-Weight GNP Deflator | 5.0 | 3.9 | 3.9 | 3.6 | 2.5 | 1.8 |
| Deflator for Imports | -1.7 | -2.1 | -0.5 | -1.0 | -7.0 | -14.6 |
| Deflator for Goods Imports Excluding Petroleum | -2.3 | -1.7 | -1.2 | -1.1 | 2.1 | 4.6 |
| Consumer Price Index (CPI) for All Urban Consumers b/ | 5.3 | 3.8 | 4.1 | 3.5 | 1.4 | -1.7 |
| Stripped CPI c/ | 6.2 | 4.3 | 4.5 | 4.5 | 4.2 | 4.5 |
| Producers Price Index (PPI), Finished Goods | 3.6 | 0.8 | 1.7 | 1.6 | -7.8 | -5.4 |
| PPI, Crude Materials | -0.8 | 4.1 | -1.2 | -6.1 | -19.3 | -21.4 |
| PPI, Crude Nonfood Materials Less Energy | -9.7 | 13.4 | -2.1 | -4.3 | -4.3 | 7.6 |
| PPI, Refined Petroleum Products | -6.0 | -9.3 | -4.6 | -1.7 | -53.4 | -65.8 |
| CPI for Food at Home | 2.6 | 1.4 | 3.8 | 1.4 | 1.5 | 0.4 |
| CPI for Energy | 1.9 | -1.5 | 0.3 | 0.9 | -15.2 | -35.2 |

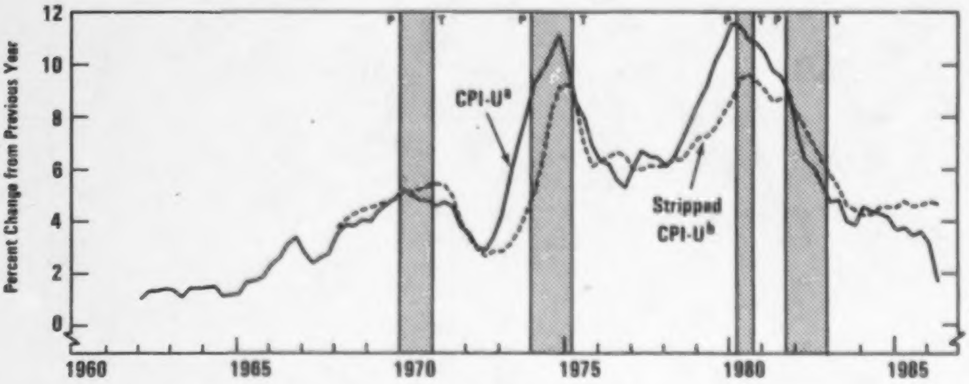
SOURCE: Bureau of Labor Statistics, U.S. Department of Labor.

a. Annualized quarterly rates.

b. The Consumer Price Index (CPI) is published in two versions: the CPI-U for all urban consumers, shown here, and the CPI-W for urban wage and clerical workers, shown in the projections in Table I-2. Before 1983, both measures used a flawed measure of the cost of homeownership; this was corrected in 1983 for the CPI-U, reported here, and in 1985 for the CPI-W. The CPI growth rates for the 1980-1982 period reported here are those of an experimental CPI measure that approximates the current CPI treatment of homeownership.

c. CPI less food at home, energy, and used cars.

Figure I-7.
Measures of Inflation



SOURCES: Congressional Budget Office; Bureau of Labor Statistics, U.S. Department of Labor.

[a] CPI-U from January 1983 to the present, prior to that time a CPI measure that is conceptually similar to the current CPI-U treatment of homeownership.

[b] CPI-U less food, energy, and used cars.

continued to move up at about a 5 percent rate, paralleling the similar divergence in wage growth between manufacturing and services. 5/

Commodity Prices. Recent overall price trends have been dominated by lower prices for crude materials, led by the dramatic fall in oil prices. The decline in the price of crude oil by nearly 60 percent since late 1985 can be largely attributed to increases in the production of oil by Saudi Arabia. In an attempt to increase its share of the world market, Saudi Arabia has more than doubled its production level since last summer. Since non-OPEC production has not fallen and world demand for oil has not increased enough to absorb the resulting oversupply, the Saudi strategy has forced a large fall in the price of oil. Reports that OPEC is raising output even further suggest that prices are likely to stay low in the near future. If, as expected, the current trends in world demand and non-OPEC supply continue through 1987, any major increase in the price of oil next year will require that OPEC countries significantly reduce their production levels.

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5. One of the most important factors has been the increase in housing costs, up about 6 percent over the past year and over 5 percent (at an annual rate) in the first half of 1986. Medical care, a smaller component, has increased even more, at about a 7½ percent rate over the past year and over 8 percent in the first half of 1986.

Prices of most other commodities used as inputs to production have also been weak over the last six months. Prices of agricultural crops have been relatively steady, for the most part, as their downward trend was stabilized by government price supports. But significant reductions in most of these support prices this summer and fall will further depress prices for most crops. Meat and poultry prices have been weak over the first half of the year, partly because of the effect on beef prices of the Dairy Termination Program. Expected declines in beef production and higher poultry demand over the next several quarters may push these prices upward somewhat, but not enough to increase food prices significantly at the retail level.

The oil price decline should continue to work to reduce inflation for some time, as lower energy prices are passed through into lower prices of other goods. But as the impact of this decline wears off, the effect of the exchange rate decline will begin to be felt throughout the price structure, pushing up the rate of inflation to an uncertain extent. Some analysts believe that the recent rapid growth of the money supply could support a substantial increase in inflation, particularly if there is a tightening in labor and product markets. Factors working in the opposite direction are the still-high unemployment rate and low capacity utilization in manufacturing.

Exchange Rates. Commonly-used estimates suggest that a 10 percent decline in the dollar might add at least 1 percent to the level of U.S. consumer prices by the time it has been fully passed through. In recent years, the dollar's rise worked to hold down consumer prices, but no longer. So far, import prices appear to have responded less than usual to the drop in the trade-weighted value of the dollar (see Figure I-8). One reason is that while the dollar has fallen sharply in the last five quarters against the yen and European currencies, it has not changed by much against the currencies of Canada, Latin America, and the Pacific rim countries which supply a very large share of U.S. imports. Furthermore, even prices of imports from Japan and Western Europe have not increased nearly as much as the depreciation of the dollar against the currencies of those countries would suggest. 6/ This delay, or possible attenuation, in import price response to

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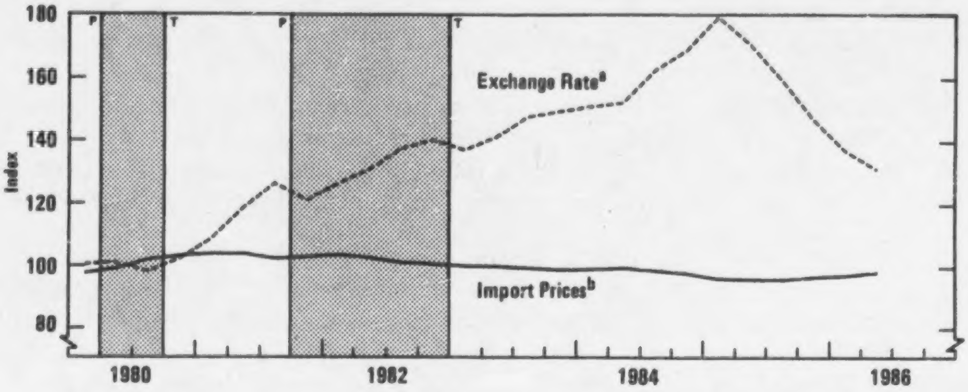
6. According to the Federal Reserve Board (FRB) exchange rate index--a commonly used measure--the dollar has depreciated by about 30 percent since its peak in February 1985. This change exaggerates the expected loss in competitiveness of imports relative to American products. The composition of the FRB index gives predominant weight to the currencies of the major European countries and Japan, against which the dollar has depreciated significantly, and little or no weight to such important U.S. trading partners as Canada and the developing countries, against whose currencies the dollar has remained relatively stable. Nevertheless, even a broader measure of the dollar's international value, which would show a smaller depreciation of the dollar from its peak, would still lead one to predict a substantial increase in import prices. Yet, nonoil import prices have increased by only a few percentage points over the last four quarters.

Figure I-8.
Exchange Rate and Import Prices



SOURCES: Congressional Budget Office; Federal Reserve Board; Bureau of Economic Analysis, U.S. Department of Commerce.

[a] Federal Reserve Board exchange rate index.

[b] Implicit price deflator for nonpetroleum merchandise imports.

the depreciation appears to be partially explained by adjustments in profit margins of Japanese and European exporters and U.S. distributors. 7/ Another factor moderating the overall response of nonoil import prices to the depreciation is that depressed market conditions have dampened prices for several important sub-groups of nonoil imports, particularly many crude and intermediate materials and components for computers, overwhelming the effects of the depreciation of the dollar.

If the United States is to achieve a substantial improvement in its foreign trade balance, prices of imports will have to rise considerably above their present levels. Such a rise would tend to increase inflation, at least for a time, especially as measured by the Consumer Price Index. (The CPI, which includes imported goods, would be affected more than the GNP de-

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7. During the period of dollar appreciation, and particularly at the time of the sharp spike in the value of the dollar that occurred in late 1984 and early 1985, foreign exporters and U.S. importers allowed their profit margins to increase abnormally, because they expected the dollar appreciation to be temporary. As the dollar fell, these businesses could afford to protect their market shares by allowing profit margins to fall back to more normal levels before raising prices. If the dollar prices of most Japanese and European goods do eventually rise, imports from Japan and Europe may be in part replaced by less expensive imports from countries whose currencies have not appreciated relative to the dollar.

flator, which is a measure of the costs of production in the United States and thus excludes costs of imports.)

Slack in the Economy. While the foregoing factors will contribute to an increase in inflation, others will work against it. Unemployment remains about 7 percent, still by most estimates at least half a point above the range where tighter labor markets can be expected to push up costs. As already noted, high unemployment, combined with foreign competition in the manufacturing sector, has held down wage growth in recent years. Capacity utilization in manufacturing is around 79 percent, and has never in this expansion exceeded the 82 percent that in the past signalled the beginning of higher inflation. If past relationships continue to hold, this amount of excess capacity taken by itself might be expected to reduce consumer price inflation by between 0.3 and 0.6 percentage points each year.

## Composition of Demand

Residential investment and consumer spending more than accounted for the increase in economic activity during the first two quarters of 1986. The upturn in housing was a response to sharply lower interest rates. The response of business fixed investment, on the other hand, was quite sluggish, reflecting excess capacity throughout most of the economy as well as a contraction in the energy sector. The international sector, where high exchange rates undercut domestic output in 1984 and 1985, has been slow to respond to the decline in the dollar that began in early 1985. Finally, changes in business inventories have as usual sharply affected GNP in the short run.

For the remainder of this year and in 1987, most forecasters look for shifts in the composition of growth, with more stimulus from the international sector and business investment but relatively less from housing. The much-needed turnaround in the U.S. trade position will depend heavily on what happens to exchange rates and on how the economy responds to it.

Inventories. Nonfarm business inventories grew substantially in the first half of the year, but the real inventory/sales ratio has not changed significantly from the levels of recent years, and is still far below its levels in the 1975-1982 period. One explanation for the lower inventory/sales ratios of the last three years is the increase in the costs of holding inventories: real short-term interest rates have increased since the late 1970s, as expected inflation has declined faster than nominal interest rates. The cost of holding commodity stocks has been particularly high because of the recent weakness in commodity prices. The CBO forecast calls for both a moderate pickup in sales and a decline in real interest rates. These factors should cause further inventory building over the next year, though at a somewhat lower rate than in the last two quarters.

Consumption. Personal consumption expenditures grew rapidly in the first half of 1986, in real terms, with a large increase in nondurable purchases in the first quarter followed by strong growth in the purchase of durable goods in the second. New car sales were a major part of the growth in durables, but purchases of appliances and furniture also jumped sharply.

Consumer spending has been buoyed by the decline in inflation. The implicit personal consumption deflator fell slightly over the six-month period ending in June, so that even though disposable income growth was only moderately higher in the first half of the year, the absence of inflation meant strong gains in real terms.

Consumers continued to rely heavily on credit. The ratio of consumer installment debt to disposable income remained near its all-time high of 19 percent. In addition, the personal saving rate increased somewhat, from 4.4 percent in the last quarter of 1985 to 5.2 percent in the second quarter, though this was due in part to large farm subsidy payments, and is still quite low by post-World War II standards. The high debt load and low saving rate have caused concern about how long current consumption rates can be sustained. For many analysts, however, the concern is mitigated by the rise in household net worth in the wake of the recent boom in stock market prices and the recent jump in the value of homes. They argue that the personal saving rate tends to be low when household net worth is relatively high, and the ratio of net worth to disposable income has been higher in recent years than at any time in the 1970s. Of course, a sharp fall in the stock market or other forms of household wealth would expose consumer debt positions, and could lead to a retrenchment in consumption.

If, as expected, inflation picks up and real disposable income growth slows in the second half of the year, the growth rate of real consumption expenditures may fall somewhat below its current pace, but a sharp retrenchment in spending does not appear likely.

Residential Construction. Falling interest rates and gains in personal income have combined to form the most advantageous home buying environment in years (see Table I-6). Sales of new homes surged in the first quarter, before slackening somewhat in the second quarter. Housing starts broke the 2 million unit mark during the first quarter of 1986--with single and multifamily units both showing strong gains--but fell off somewhat during the second quarter as multifamily starts dropped sharply. Vacancy rates (not shown in the table) also rose during the second quarter. While the

TABLE I-6. SELECTED HOUSING DATA

| | Starts (millions) | | | Sales (millions) | | Inventory (months) | Interest Rates (percents) | | Permits (millions) | New Homes Median Price (thousands) | Affordability Index a/ |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Total | Single-Family | Multi-Family | New | Existing | | Commitment Rate | One-Year T-Bill | | | |
| 1985:I | 1.76 | 1.10 | 0.66 | 0.669 | 2.96 | 6.5 | 13.06 | 9.39 | 1.67 | 82.9 | 0.81 |
| 1985:II | 1.74 | 1.07 | 0.67 | 0.681 | 3.04 | 6.3 | 12.78 | 8.47 | 1.71 | 84.0 | 0.84 |
| 1985:III | 1.69 | 1.05 | 0.64 | 0.711 | 3.36 | 6.0 | 12.14 | 7.99 | 1.78 | 83.4 | 0.88 |
| 1985:IV | 1.77 | 1.07 | 0.70 | 0.696 | 3.50 | 6.0 | 11.73 | 7.85 | 1.74 | 86.8 | 0.87 |
| 1986:I | 2.00 | 1.25 | 0.75 | 0.800 | 3.26 | 5.4 | 10.56 | 7.46 | 1.83 | 88.3 | 0.89 |
| 1986:II | 1.91 | 1.24 | 0.67 | 0.789 | 3.48 | 5.3 | 10.25 | 6.61 | 1.81 | 91.6 | 0.90 |

SOURCES: Congressional Budget Office; Federal Home Loan Mortgage Corporation; Bureau of Census, U.S. Department of Commerce; Federal Reserve Board.

a. The percent of households that can afford the median-priced home. Calculated by the Congressional Budget Office.

expected modest rise in interest rates in 1987 may cause starts of single-family homes to slow slightly, financial conditions for this segment of the construction industry should remain favorable throughout most of this year and next.

The tax reform debate, however, has created some uncertainty regarding starts of multifamily units. Under the Senate bill, rental units not in service by the end of this year would not be eligible for certain tax shelter benefits. This could cause starts of multifamily units to fall in the last half of 1986, especially if they have been boosted in anticipation of these changes.

Government Purchases. Expenditures by the public sector contributed to overall economic growth in 1985, and have helped to offset the decline in growth during the current year. Slower growth in real public-sector purchases is expected to be a drag on the economy during most of the forecast period.

Following recent declines, federal purchases of goods and services (excluding the Commodity Credit Corporation) soared by 12.7 percent (annual rate) in the second quarter--the second strongest growth in the 15 years of data available for this series. An acceleration in defense spending (especially durables) accounted for nearly all of this growth (see Table I-7). Another quarter of growth in defense purchases seems likely. But under the Balanced Budget Act, a downward trend in real federal defense and nondefense purchases is expected throughout the rest of the forecast period, tending to slow the overall growth of the economy.

The growth of real state and local purchases also soared in the second quarter--the result of a surge in construction spending (51.2 percent at annual rates). This flurry followed record borrowing at the end of last year, undertaken largely in reaction to tax reform proposals that would increase restrictions on tax-exempt borrowing by state and local governments. The outlook is for some decline in construction activity and only moderate gains in other purchases. The growth of purchases will be restrained by slow growth in revenues stemming in part from the termination of general revenue sharing as well as other cutbacks in federal grants. On the other hand, a recent rebound in state and local borrowing should help to bolster the growth of capital spending for a while.

The operating surpluses of state and local governments amounted to $9.0 billion in 1985. In the first quarter of 1986, these balances jumped to $15.7 billion, but most of this surplus reflected a rebate payment from federal fines levied against Exxon for past overcharges. Although some states will be receiving nonrecurring federal grants (settlement payments from dis-

TABLE I-7. GOVERMENT PURCHASES OF GOODS AND SERVICES (NIPA basis)

| | 1984 a/ | 1985 a/ | 1985 | | | | 1986 | |
|---|---|---|---|---|---|---|---|---|
| | | | I | II | III | IV | I | II |
| | | | | **Billions of 1982 Dollars** | | | | |
| Federal Purchases b/ | 293.9 | 311.2 | 302.6 | 309.4 | 318.3 | 314.9 | 314.0 | 323.5 |
| Defense | 219.4 | 235.7 | 228.0 | 233.5 | 242.2 | 239.3 | 238.7 | 247.5 |
| Nondefense b/ | 74.5 | 75.5 | 74.6 | 75.9 | 76.1 | 75.6 | 75.3 | 76.0 |
| State and Local Purchases | 383.5 | 397.6 | 389.5 | 396.9 | 401.9 | 402.2 | 404.8 | 412.4 |
| | | | | **Percent Change** | | | | |
| Federal Purchases b/ | 5.2 | 5.9 | -0.5 | 9.2 | 12.0 | -4.2 | -1.1 | 12.7 |
| Defense | 6.0 | 7.4 | 3.8 | 10.0 | 15.8 | -4.7 | -1.0 | 15.6 |
| Nondefense b/ | 2.9 | 1.3 | -12.4 | 7.2 | 1.1 | -2.6 | -1.6 | 3.8 |
| State and Local Purchases | 2.6 | 3.7 | 1.9 | 7.8 | 5.1 | 0.3 | 2.6 | 7.7 |

SOURCES: Congressional Budget Office; Bureau of Economic Analysis, Department of Commerce.

a. The percent changes for calendar years 1984 and 1985 are calculated on a year-over-year basis.

b. Excludes the activities of the Commodity Credit Corporation.

puted Outer Continental Shelf revenue), the outlook is for slower revenue growth and much smaller operating balances during the forecast period. This deterioration in budget positions will require austerity measures in some states. 8/ At the same time, trust fund surpluses are expected

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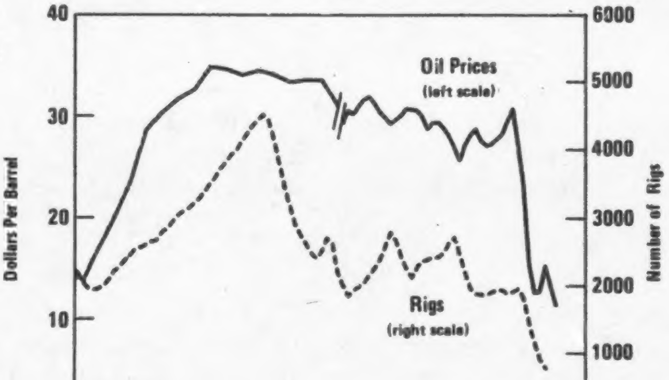
8. However, passage of a tax reform bill that broadens the personal tax base would produce windfall gains for most states that use the federal definition of taxable income.

to grow somewhat more slowly than in recent years, providing less of an offset than otherwise to federal borrowing needs.

Business Fixed Investment. Business fixed investment is a pivotal sector of the economy at present. After growing far more rapidly than overall GNP in 1984 and 1985, it seems likely to contribute little, if any, to growth in real GNP this year. In the near term, several factors are holding back aggregate investment, including the slump in the petroleum industry, relatively low levels of capacity utilization, uncertainties over tax legislation, and overbuilding in some sectors, especially in office buildings. Other factors, however, such as lower interest rates and a generally buoyant stock market, should promote investment growth. If spending in the rest of the economy accelerates in the next few quarters as CBO expects, capacity utilization should improve--and that would also be a major positive influence on investment. By next year, this sector may show more strength, assuming that output of final goods rises as projected by CBO.

Real business fixed investment declined sharply in the first half at a 9.1 percent annual rate, with structures accounting for most of the decline. This decline was in part a reaction to a sharp rise in the fourth quarter, when businesses hurried to qualify for the investment tax credit, but the major near-term negative influence was the dramatic decline in oil prices. Drilling for oil and gas, which accounted for about 23 percent of investment in structures last year, has fallen drastically since late 1985 (see Figure I-9).

Figure I-9.
Oil Prices and Oil Rigs in Operation



SOURCES: Congressional Budget Office; Directorate of Intelligence, Central Intelligence Agency; New York Merchantile Exchange; Hughes Tool Company.

NOTE: The price series is the official OPEC price (quarterly data) until 1983:1. The N.Y. Merchantile Exchange forward price for oil to be delivered in the next month is used thereafter.

Low rates of capacity utilization are currently a more fundamental short-run drag on investment. Historically, capacity utilization and investment have tended to move together. As shown in Figure I-10, investment accelerated as capacity utilization increased in 1983 and 1984. After that, however, capacity utilization leveled out near its long-term average, and more recently it dipped below 80 percent; correspondingly, the pace of investment has flattened in recent quarters. The current overhang of too much commercial building is also retarding investment. In particular, vacancy rates for office buildings are relatively high, and in some geographic areas extremely high.

Proposed tax legislation may be deterring investment in equipment this year. The tax bills passed by both the Senate and the House of Representatives would repeal the investment tax credit, which generally applies only to equipment. The effective date for the repeal is January 1, 1986 for both bills. The Senate bill would provide for more rapid depreciation for most equipment, but this provision would not be effective until January 1, 1987, thus offering an incentive to defer investments in equipment until 1987. By contrast, since the Senate bill would cut back on depreciation for structures on January 1, 1987, there may be an incentive to complete investments in structures this year to qualify for more rapid depreciation

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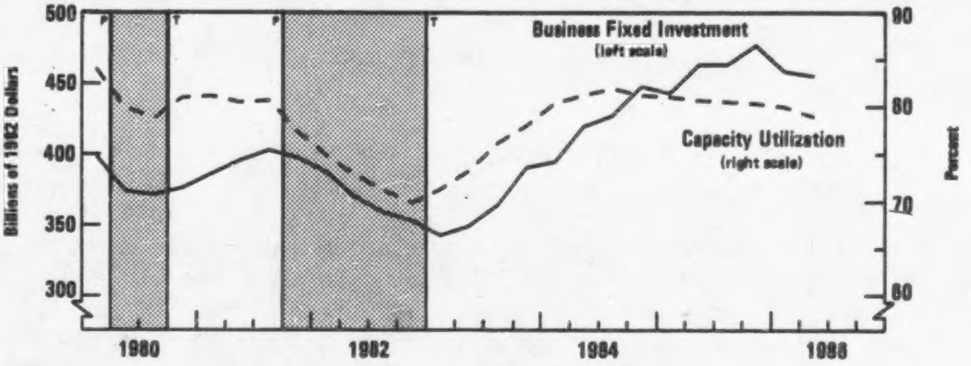
Figure I-10.

**Real Business Fixed Investment and Total Industry Capacity Utilization**



SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; Federal Reserve Board.

To the extent that tax incentives have contributed to and prolonged the boom in commercial construction, however, their repeal could possibly dampen spending.

Current indicators of business fixed investment have generally been lackluster, and surveys of capital spending plans confirm the outlook for flat capital spending this year (see Table I-8). The recent survey by the Commerce Department indicates that businesses plan to spend about the same amount in 1986 as in 1985--up only 0.2 percent in current dollars. Allowing for the Commerce Department's adjustment for changes in capital goods prices, real spending would be down 1.3 percent.

In 1987 conditions should be more favorable for investment than in 1986. The effects of lower oil prices on petroleum-related investment should constitute a smaller drag on overall investment in 1987, and the recent declines in interest rates together with the increases in the stock market should by then have had a positive effect. More important in the short term, however, should be the stimulative effects on sales from lower oil prices and interest rates, and the declining dollar.

Net Exports. During the first half of 1986, the dollar continued its decline against most other major currencies, as had been expected. Factors underlying the dollar's decline in the latter half of 1985 continued to be important, such as:

- Sluggish growth in the domestic economy and associated sluggish growth in credit demands early in 1986;
- An accommodative U.S. monetary policy (see the next section); and
- An improved likelihood that the federal deficit will be gradually reduced.

One result of these factors was that long-term interest rates in the United States continued to fall in early 1986 relative to those abroad. Relative interest-rate differentials fell at a much slower pace than in late 1985, however, because monetary authorities in the major foreign industrial countries progressively lowered their interest rates, sometimes in coordination with U.S. authorities. In fact, the real long-term interest-rate differential moved against the U.S. dollar in May and June, as shown in Figure I-11. The sharpness of the dollar's decline in the first half of 1986 was probably attributable in part to a number of other factors that affected international confidence in the value of the dollar. Persistent signs of strain in the U.S. banking system (energy and farm loan difficulties, insolvency of many thrift

## TABLE I-8. CURRENT INDICATORS OF BUSINESS FIXED INVESTMENT AND SURVEYS OF CAPITAL SPENDING PLANS FOR 1986

| | 1984 | 1985 | 1985 I | 1985 II | 1985 III | 1985 IV | 1986 I | 1986 II |
|---|---|---|---|---|---|---|---|---|
| **Current Indicators** | | | | | | | | |
| Nondefense Capital Goods Orders (billions of dollars per month) | 27.0 | 27.2 | 26.8 | 26.3 | 27.8 | 27.8 | 26.5 | 26.3 |
| Manufacturers' Capital Appropriations (billions of dollars, quarterly rate) a/ | 29.0 | 26.8 | 29.9 | 27.6 | 24.2 | 27.2 | 24.5 | n.a. |
| Capacity Utilization (percent) | 81.2 | 80.6 | 81.0 | 80.7 | 80.5 | 80.3 | 79.9 | 78.9 |
| Corporate Economic Profits (billions of dollars, annual rate) b/ | 265 | 281 | 266 | 274 | 296 | 286 | 296 | n.a. |
| Corporate Net Cash Flow (billions of dollars, annual rate) c/ | 345 | 375 | 361 | 372 | 389 | 380 | 397 | n.a. |
| Corporate AAA Bond Rate (percent) | 12.7 | 11.4 | 12.3 | 11.6 | 11.0 | 10.6 | 9.6 | 9.0 |
| Standard and Poor's 500 Stock Index (annual percent change) | 0.0 | 16.4 | 32.7 | 18.0 | 7.8 | 19.7 | 55.5 | 43.1 |

**Surveys of Capital Spending Plans for 1986 (In percents)**

| | Nominal | Real |
|---|---|---|
| U.S. Department of Commerce d/ | 0.2 | -1.3 |
| McGraw-Hill Survey e/ | -0.5 | -4.1 |

SOURCES: Congressional Budget Office; Bureau of Economic Analysis, U.S. Department of Commerce; McGraw-Hill, Inc.; Conference Board; Federal Reserve Board.

NOTE: n.a. = not available.

a. Because of the seasonal adjustment procedure, the annual figure does not equal the average of the quarterly figures.

b. Economic profits are adjusted for inventory valuation and capital consumption allowances.

c. Net cash flow equals corporate retained earnings with inventory valuation adjustment, plus economic depreciation.

d. Conducted in April and May 1986.

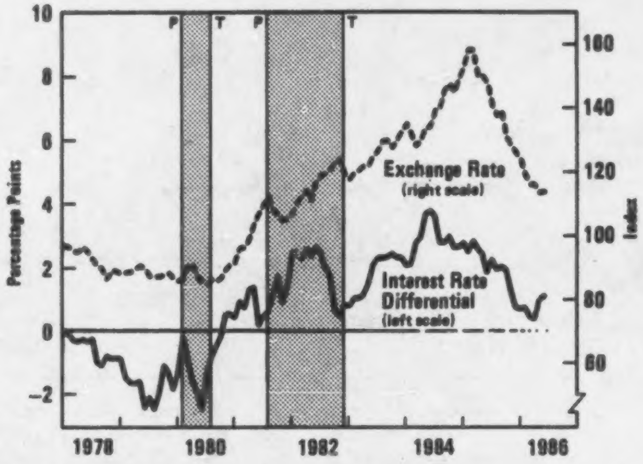
e. Conducted in March and April 1986.

institutions, and a record number of bank failures) may have deterred international investors from adding to their dollar holdings at the rate they did earlier. Although the value of the dollar may level off for a time as the domestic economy strengthens and interest rates in the United States firm, CBO expects it will ultimately decline further.

So far, the depreciation of the dollar has not been reflected in an improved U.S. trade position. The real trade deficit continued to deteriorate in the first half of 1986, but at a slower pace than recorded in 1985. Most of the deterioration can be attributed to increased imports from countries whose currencies had depreciated the most in real terms against the dollar between 1980 and February 1985--major Western European countries and Japan. The share of automotive and consumer (nonfood and nonauto) goods in total merchandise imports continued to rise substantially, and the share of capital goods--even with only moderate growth in the U.S. economy--continued to rise as well. Petroleum imports displayed sharp quarter-to-quarter swings in response to the collapse in oil prices: the volume increased significantly in the second quarter of 1986, as inventories needed to be replenished following very low levels of imports in the first quarter, but nominal petroleum imports fell significantly in both quarters as the impact of the lower prices overwhelmed changes in volume.

Figure I-11.

The Exchange Rate and Relative Interest Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; International Monetary Fund.

NOTE: The exchange rate is a trade-weighted average of bilateral dollar exchange rates. The real interest-rate differential is the difference between long-term real interest rates for the United States and a GDP-weighted average for other industrial countries. Long-term real interest rates are long-term nominal interest rates (on government bonds), adjusted for expected inflation rates. Expected inflation is proxied by a two-year centered moving average of actual and projected CPI inflation rates.

Real merchandise exports have continued a relatively slow improvement; the subdued pace of economic growth overseas, and severe financial difficulties for Latin American countries appeared to offset somewhat the effects of the depreciation of the dollar. Real nonagricultural exports have risen moderately over the last three quarters, with capital goods and industrial supplies the only strong performers. Agricultural exports have continued their prolonged slump, in both real and nominal terms, in response to long-run excess supply conditions in world markets. [9] Thus, growth in exports was not nearly enough to prevent the further worsening of the trade balance.

Total net services and net investment income flows deteriorated considerably in 1985 before improving slightly in the first quarter. On a national income and product account (NIPA) basis, net investment income flows declined in 1985 relative to 1984 as a whole, in both nominal and real terms, thereby lowering the growth rate of real GNP some three-tenths of a percentage point below the growth rate of domestic output. The improvement in the first quarter of 1986 proved to be only temporary as both total net services and net investment income flows declined in the second quarter. The net balance for other (noninvestment income) services improved, however, throughout the entire first half of 1986.

Most forecasters expect real net exports to improve significantly in the near future, contributing importantly to economic growth by 1987. But the timing of the turnaround is highly uncertain, especially given the slower than expected response of import prices to the depreciation of the dollar (for reasons discussed earlier in this chapter) and the possibility of continued weak growth among U.S. trading partners.

## FISCAL AND MONETARY POLICY

In its annual report last February, CBO noted that the mix of fiscal and monetary policy was shifting. At present, fiscal policy under the requirements of the Balanced Budget Act is headed toward a restrictive course, while monetary policy has remained accommodative to economic expansion (see Figure I-12). If these trends continue, the new policy combination should be more conducive to capital formation and long-term growth than were earlier policies.

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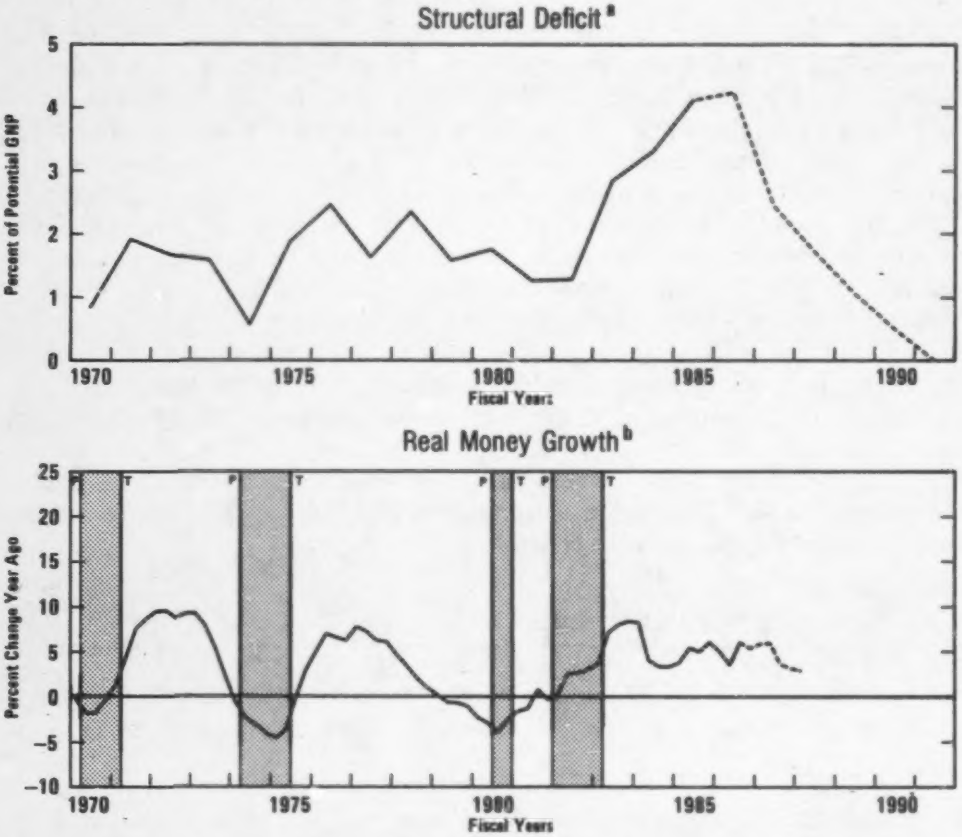
[9] Currently, U.S. agricultural exports are in a state of flux as markets adjust to the government-mandated drop in price support or loan rate levels for most crops this summer and autumn. Since the timing of these price declines has been known since early in the year, foreign buyers have had an incentive to defer purchases until the commodities became available at the lower prices. Once prices drop, the volume of exports is expected to rise sharply, especially during periods immediately after the price changes, to meet pent-up demand. This pattern is already evident for wheat, exports of which fell perceptibly before the drop in the loan rate in June and have since registered large gains.

Figure I-12.

Fiscal and Monetary Indicators



SOURCES: Congressional Budget Office; Bureau of Economic Analysis, Department of Commerce; Federal Reserve Board; Bureau of Labor Statistics, Department of Labor.

[a] Forecasted values based on Balanced Budget Act targets.

[b] M2 deflated by the CPI-U. Forecasted values based on midpoint growth rates of the Federal Reserve Board's target bands for 1986 and 1987, and CBO's forecast of CPI-U.

## Fiscal Policy

The outlook for fiscal policy continues to be one of greater restraint. CBO estimates that the budget deficit will be $224 in fiscal year 1986, and $184 billion in 1987, taking into account only those policies already in place (see Chapter II). The CBO economic projection, however, and the following discussion of fiscal policy are based upon the assumption that the Congress

TABLE I-9. AGGREGATE MEASURES OF FISCAL POLICY
(Fiscal years, unified budget basis)

| Measure | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|
| | | | Billions of Dollars | | | | |
| Standardized-Employment Deficit | | | | | | | |
| Baseline | 168 | 184 | 151 | 126 | 110 | 87 | 68 |
| Balanced-budget target | 168 | 184 | 111 | 84 | 55 | 28 | -1 |
| Publicly Held Debt | | | | | | | |
| Baseline | 1,510 | 1,739 | 1,925 | 2,071 | 2,195 | 2,290 | 2,358 |
| Balanced-budget target | 1,510 | 1,739 | 1,884 | 1,989 | 2,058 | 2,093 | 2,092 |
| | | | Percent of Standardized GNP | | | | |
| Standardized-Employment Deficit | | | | | | | |
| Baseline | 4.1 | 4.3 | 3.3 | 2.6 | 2.1 | 1.6 | 1.2 |
| Balanced-budget target | 4.1 | 4.3 | 2.5 | 1.7 | 1.1 | 0.5 | -0.0 |
| Publicly Held Debt a/ | | | | | | | |
| Baseline | 38.3 | 41.8 | 43.5 | 43.6 | 43.0 | 41.8 | 40.1 |
| Balanced-budget target | 38.3 | 41.8 | 42.6 | 41.8 | 40.3 | 38.2 | 35.6 |

SOURCE: Congressional Budget Office.

a. These numbers are expressed relative to GNP rather than to standardized GNP.

will undertake whatever spending cuts and/or revenue increases needed to achieve the Balanced Budget Act deficit targets. 10/

To gauge the degree of discretionary fiscal policy restraint (or stimulus), it is customary to look at the movement in the budget along some hypothetical path that serves to isolate the deficit from the budgetary effects of fluctuations in output and employment. Table I-9 reports such a measure--the standardized-employment deficit; this is the deficit projected at a constant 6.0 percent rate of unemployment. According to this measure, fiscal policy will become quite restrictive in the coming year as the standardized-employment deficit declines from 4.3 percent of standardized GNP in 1986 to 2.5 percent in 1987. 11/ If there are no large increases in asset sales, this move would represent one of the largest annual shifts toward restraint in the past three decades. However, some increase in asset sales is anticipated by the budget resolution and the Administration may recommend further increases. As explained in the box, deficit reduction achieved by asset sales does not exert a contractionary effect on the economy and does not reduce credit demands because asset sales are simply a substitute for Treasury borrowing. Continued adherence to the deficit targets of the Balanced Budget Act of 1985 would approximately balance the standardized-employment deficit by 1991, given a projected unemployment rate of 6.0 percent in that year. The result would be the largest sustained amount of fiscal restraint in more than 30 years. 12/

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10. Since all the specific policies that will be enacted to reach these targets are not yet known, it was assumed that the deficit reductions necessary to achieve the budget targets will involve both cuts in spending and tax increases.

11. These estimates do not incorporate the tax changes proposed in the tax reform bills, which might affect some measures of aggregate fiscal stimulus. These numbers do, however, include $1.4 billion of financial asset sales in 1986 and $6.0 billion in 1987, including the policies of the Budget Resolution.

12. Other measures of fiscal policy show similar degrees of fiscal restraint. Table I-9 shows that the federal debt declines relative to GNP. Such a fall in this ratio generally is viewed as favorable to credit market conditions. The standardized primary deficit, which excludes interest costs and receipts, also shows reduced stimulus. Interest payments on the federal debt have grown considerably in recent years, and some analysts argue that (1) these outlays are not controllable at least in the short run, and (2) they may have relatively less impact on aggregate demand since a substantial component of interest outlays merely compensates bondholders for the loss in the value of their bondholdings due to inflation. When federal interest payments and receipts are excluded from the calculation of the standardized-employment deficit, the resulting measure of stimulus falls from 2.3 percent of standardized GNP in 1986 to a 1.4 percent surplus in 1991, assuming the target path of the Balanced Budget Act of 1985. For other considerations in measuring fiscal policy, see Robert Eisner, *How Real is the Federal Deficit?* (New York: The Free Press, 1986).

Economists generally agree that smaller federal deficits will encourage private capital formation and have a favorable impact on economic growth in the long run. There is a wide dispersion of views, however, as to the short-run consequences of fiscal restraint. According to the standard Keynesian model, reductions in federal spending of the magnitudes now projected would have a magnifying and thus very depressing impact on the economy, at least temporarily, unless offset by monetary expansion or other factors. In the context of flexible exchange rates and efficient international capital markets, however, this depressing effect should be at least partially offset over time. The reason is that a reduction in the budget deficit puts downward pressure on U.S. interest rates, and as a result less capital is attracted from international capital markets. A reduction in net capital inflows should lower the value of the U.S. dollar and eventually reduce the trade deficit, provided that lower income growth abroad does not offset this stimulus to U.S. exports.

Some versions of the new classical model, which assign prominence to economic behavior based on expectations, go further and argue that a reduction in federal spending has no effect on output and employment unless unanticipated. 13/ Finally, the strict monetarist model maintains that fiscal restraint would not significantly depress aggregate output and employment even in the short run, but would instead alter the composition of activity in favor of investment and other relatively interest-sensitive components. 14/

In any event, as discussed earlier in this report, other important developments could offset the contractionary effects of fiscal restraint. These include the recent large drop in energy prices and the continuing fall in the international exchange value of the dollar, which, as suggested above, may be related to the improved prospects for deficit reduction. The net effect of all these factors (including fiscal restraint) on short-term growth depends in part on how fast the impact of each factor works its way through the economy. Given that oil prices and the exchange rate already have declined substantially during the past year, these stimulative factors could dominate the short-term outlook, especially if the complete response to fiscal restraint is not immediate.

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13. **Some adherents to the new classical views, however, maintain that a reduction in federal spending would lower output and employment, especially if the spending reduction was temporary and not a perfect substitute for private spending. See Robert J. Barro, "Output Effects of Government Purchases," *Journal of Political Economy* (1981), pp. 1086-1121.**

14. **Empirical estimates with a monetarist model generally show output declining temporarily. But over a period of a year or so, the net effect is negligible.**

## ASSET SALES AND FEDERAL DEFICIT TARGETS

Although the federal government is a net debtor, it nevertheless owns a very large amount of financial and tangible assets. Some analysts argue that economic efficiency would be improved if the government divested itself of some of these assets. Because the sale of financial assets acquired through federal lending would provide a measure of the federal subsidy (the difference between the loan value and the market value of the asset), asset sales may also permit better-informed policy decisions. It is also frequently proposed that the sale of federal assets would help the government reduce budget deficits. The discussion in this box does not address the issue of efficiency, but does examine three other issues regarding the sale of federal financial assets: the appropriate budgetary treatment of such sales, the long-run effects on budget deficits, and resulting distortions in the measurement of fiscal policy.

Budgetary Treatment. By convention, receipts from the sale of federal assets are recorded as negative outlays in the budget, and thus reduce the size of the federal deficit. In this respect, selling federal assets has the same current impact on the reported budget deficit as reducing federal spending. Many analysts, however, argue that this treatment is misleading, claiming that it would be more appropriate to view asset sales as a means of financing the deficit rather than as a reduction in spending. In fact, the Commerce Department excludes the proceeds of asset sales from the federal deficit in the national income and product accounts.

Nevertheless, the significant shift in fiscal policy does entail some risk. There is considerable uncertainty about the timing and magnitude of fiscal effects, especially with regard to whether they are offset by movements in the trade balance. Conceivably, the contractionary impact of the fiscal policy shift could slow the economy before its indirect stimulative effects on the trade balance and interest-sensitive spending take hold. CBO does not assume that this will happen, but the possibility is one more factor making the current forecast even more uncertain than usual.

Long-Run Deficit Effects. While asset sales immediately reduce the reported federal deficit under current budgetary conventions, they may increase future deficits. On the one hand, cash from the asset sale can be used to retire outstanding debt, saving on future interest expense. On the other hand, the government no longer receives the revenues from the payment of interest and principal on these loans. Selling the loans means that future deficits will be larger so long as the forgone receipts from the asset exceed the interest savings on the retired debt.

Distortions in Fiscal Policy Measures. Most economists would agree that reducing the deficit through asset sales would have no direct short-run impact on output and employment. In this respect, asset sales are merely a substitute for Treasury bond sales, and as such have the same net effect on total credit demand. Like Treasury bond sales, they absorb private credit. Therefore, with asset sales, the federal deficit is not a good measure of federal credit absorption. In other words, asset sales do not increase national saving as would a reduction in federal spending.

Given the short-run neutral effects of asset sales on the total demand for goods and services, measures of fiscal policy such as the structural budget deficit are likely to overstate the degree of fiscal restraint if they include increases in the sale of federal assets. In most past years, the level of asset sales has not been large (less than $3 billion) compared with the deficit, and thus has not significantly distorted budget-based measures of fiscal restraint. But if asset sales become a major component of deficit reduction measures, the projected structural budget deficit shown in Figure I-12, would significantly exaggerate the degree of fiscal restraint.

## Financial Markets and Monetary Policy

Notwithstanding the recent fall in the stock market, 1986 has marked a continuation of the rally in financial markets that began in mid-1984. The decline in interest rates to levels not seen since the latter 1970s is the outcome of several different factors: slowing economic activity, reduced inflation, accommodative monetary policy, and efforts to cut the projected federal deficit.

Although both short- and long-term interest rates fell sharply through the first four months of this year, the drop was much more pronounced for the longer maturities (see Figure I-13). The resultant flattening in the yield curve triggered a significant volume of debt restructuring as firms sought to take advantage of the relatively low long-term rates. Beginning in late April, concern that the drop in the international value of the dollar might spur inflation caused rates to rise again, but they have now dropped back close to their previous lows. The prospect of more rapid economic growth in

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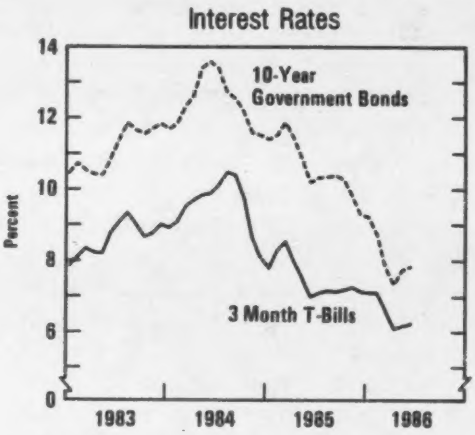
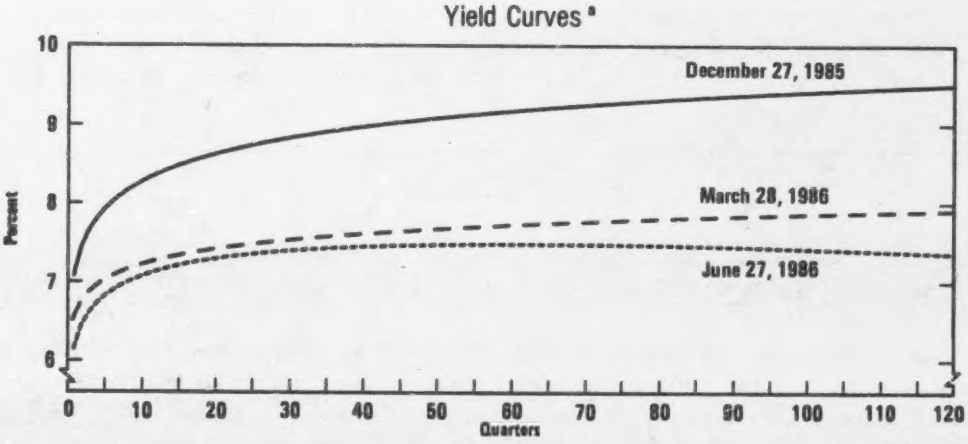
Figure I-13.

**Recent Short- and Long-Term Interest Rate Movements**





SOURCES: Congressional Budget Office; Federal Reserve Board.

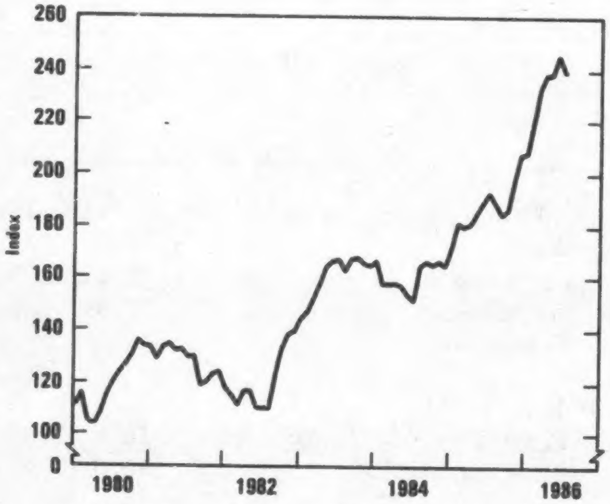
ª These curves were fitted to weekly average yields on Treasury instruments using a logarithmic function described by Bradley and Crane in the *Journal of Bank Research*, Spring 1973.

the second half of the year has led some forecasters, including CBO, to expect a modest pickup in nominal interest rates toward year-end and into 1987, though real rates are expected to decline. Some forecasters expect relatively flat rates through mid-1987--as suggested by the expectations embodied in the yield curve and the futures market.

The stock market, as measured by the Standard and Poor's Index of 500 Stocks, rose 26 percent in 1985 and then surged to new highs again this year, rising over 18 percent in the first six months (see Figure I-14). In recent weeks, however, the market has retracted some of the gains in the first half. While the increase in stockholders' wealth may be helping to sustain consumer spending, a prolonged decline in the stock market, by reversing the gains in wealth, could have the opposite effect on consumer spending.

Credit Flows. During the first quarter of this year, both the public and private sectors reduced their borrowings. Households continued to buy on installment credit but sharply curtailed their net acquisition of new mortgage credit. It is possible that many new mortgages were displaced by the surge in refinancing of old ones, and originations will pick up once the bulge in refinancing has run its course. Corporations have taken advantage of lower long-term rates to restructure their balance sheets but have postponed borrowing to fund new capital expenditures. Surveys of planned

Figure I-14.
Common Stock Prices (Standard and Poor's "500")



SOURCES: Congressional Budget Office; Standard and Poor's Corporation.

capital expenditures suggest that corporate demand for credit may remain relatively sluggish.

By far the largest decline in the rate of growth of debt has been in the public sector, especially at the state and local level. During 1985, states and localities issued a record amount of securities, in large part because of pending federal tax reforms that would place more restrictions on tax-exempt financing beginning in 1986. After a sharp decline in the first quarter, state and local borrowing has once again been increasing following a change in the effective date for some of the tax reform proposals. Credit demands by state and local governments are expected to remain moderately strong, at least in the near term, despite the uncertainty over tax reform. At the same time, the volume of federal credit demand is expected to decline in 1987, but to remain much larger than state and local borrowing.

Monetary Policy. By most measures, monetary policy in 1986 has continued to accommodate economic growth. M1, which apparently is becoming an increasingly unreliable indicator of monetary stimulus, surged at a 13.2 percent annual pace over the first half of this year, well above the 3 percent to 8 percent target (see Figure I-15). The burst in M1 has left it over $17

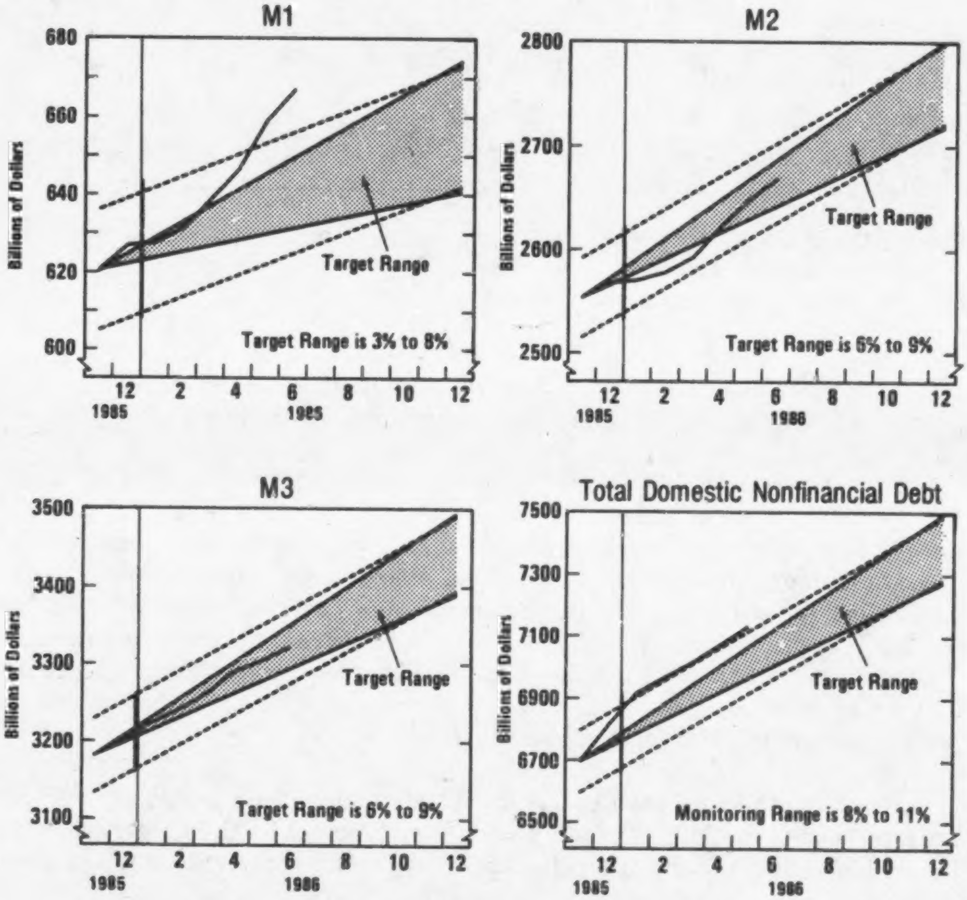
TABLE I-10. GROWTH RATES OF CREDIT MARKET DEBT, NONFINANCIAL SECTORS (Percent change at annual rates)

| Sector | 1985 I | 1985 II | 1985 III | 1985 IV | 1986 I |
|---|---|---|---|---|---|
| Total Nonfinancial Debt | 11.4 | 12.6 | 12.8 | 20.9 | 8.6 |
| Private | 11.5 | 11.5 | 13.0 | 19.5 | 8.8 |
| Corporate | 11.8 | 10.6 | 9.0 | 13.8 | 11.7 |
| Household | 12.0 | 12.0 | 15.1 | 16.8 | 8.4 |
| Foreign | -1.3 | -1.3 | 4.8 | 0.5 | -4.1 |
| Public | 12.0 | 17.9 | 15.6 | 37.6 | 6.9 |
| Federal | 10.9 | 16.6 | 12.0 | 26.0 | 7.7 |
| State and Local | 15.6 | 22.0 | 28.2 | 79.3 | 4.6 |

SOURCES: Congressional Budget Office; Federal Reserve Board.

billion above its target as of June, and has prompted the Federal Reserve to de-emphasize the role of this aggregate in its midyear economic report to the Congress. M2 and M3 grew at rates of 8.2 percent and 7.8 percent,

Figure I-15.
Money Growth and Targets in 1986



SOURCES: Congressional Budget Office; Federal Reserve Board.

NOTE: Dotted lines refer to growth bands that the Federal Reserve Board considers consistent with its targets.

TABLE I-11. SELECTED MONETARY POLICY MEASURES

| Time Period | Money Base Growth a/ | Total Reserve Growth a/ | Seasonal and Adjustment Borrowings b/ | Federal Funds Rate-Discount Spread (in percents) |
|---|---|---|---|---|
| 1985:II | 7.6 | 12.4 | 598 | 0.15 |
| 1985:III | 10.0 | 16.7 | 579 | 0.40 |
| 1985:IV | 8.4 | 13.1 | 862 | 0.60 |
| 1986:I | 8.9 | 13.8 | 302 | 0.46 |
| 1986:II | 9.0 | 19.0 | 274 | 0.31 |

SOURCE: Federal Reserve Board.

a. Seasonally adjusted annual rates of change.

b. Millions of dollars, not seasonally adjusted.

respectively, in the first half of the year, well within their 6 percent to 9 percent targets but slightly faster than in the second half of last year. 15/

As shown in Table I-11, the reserve aggregates tell a similiar story. The monetary base is expanding at about the same rate as during the last half of 1985, and total reserves are expanding slightly faster. Seasonal and adjustment borrowings from the Federal Reserve are running at less than half of last year's level, and in the second quarter the spread between the federal funds rate and the discount rate fell to about 30 basis points--both indications of a somewhat easier Federal Reserve stance. The Federal Reserve also lowered the discount rate to 6 percent with three cuts of half a percentage point in March, April, and July.

In July, the Federal Reserve Board also announced tentative 1987 aggregate targets for M2, M3, and debt. The targets for the broader Ms were lowered one-half percentage point to a range of 5½ percent to 8½ percent,

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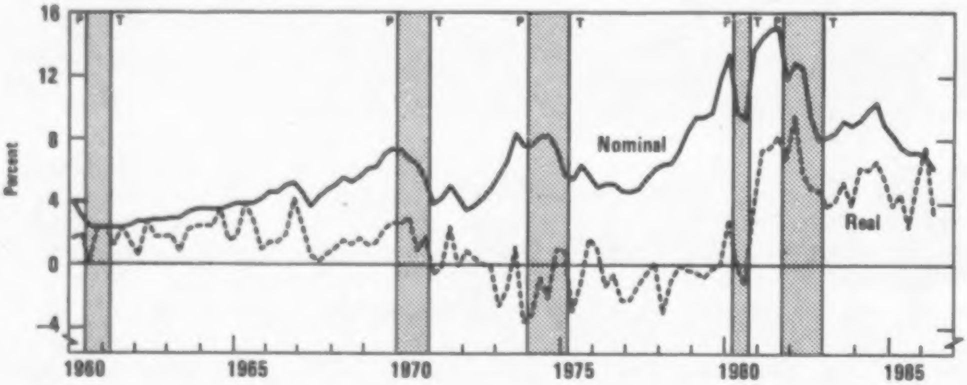
15. M1 consists of currency, travelers' checks, demand deposits, and other checkable deposits. M2 consists of M1 plus overnight repurchase agreements, Eurodollars, money market mutual fund balances, money market demand accounts, and savings and small time deposits. M3 consists of M2 plus large time deposits, term repurchase agreements, term Eurodollars, and other institutional funds.

while the debt target was unchanged at 8 percent to 11 percent. These tentative targets for M2 and M3, together with the Federal Reserve's expectation for GNP growth of 5 percent to 8½ percent, imply that the Board expects M2 and M3 velocity to begin growing at close to their respective trends without making up for the shortfall in the level of velocity over the past five years. In keeping with the de-emphasis on M1, the Federal Reserve anounced that a tentative target for M1 of 3 percent to 8 percent (the same as in 1986) would be appropriate "if more stable velocity behavior shows signs of re-emerging."

While these tentative targets and accompanying statements by the Federal Reserve point toward a continued accommodative monetary policy, its effect on economic activity is more uncertain because of the decline in the income velocity of money (see the box). Some analysts see the rapid money growth as a harbinger of future inflation, while others point to the flattening of the yield curve, the still historically high short-term real interest rates, and the weakness in many commodity prices as evidence that monetary easing has some way to go before it will boost economic growth, let alone trigger inflation (see Figure I-16). Although a marked flattening in

Figure I-16.
Three-Month Treasury Bill Rates



SOURCES: Congressional Budget Office; Federal Reserve Board; Bureau of Economic Analysis, U.S. Department of Commerce.

NOTE: Real interest rates are calculated by subtracting from the nominal interest rate the rate of inflation in the succeeding quarter. This value, the "ex post real rate," is the proxy for the unobserved real rate, which is the nominal rate less expected inflation over the life of the instrument. The inflation rate used is that of the fixed-weight consumption price index and is assumed to be 2.7 percent in the third quarter of 1986.

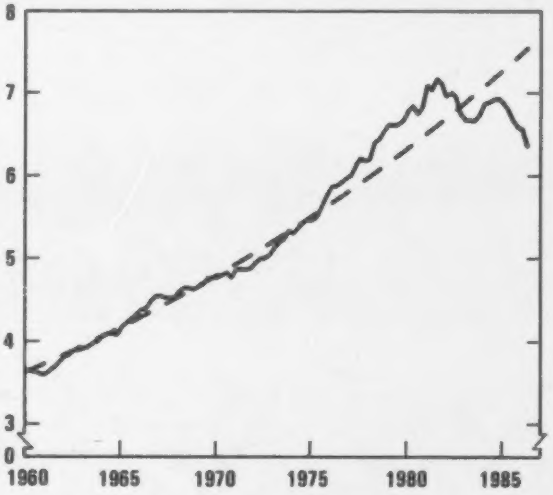
## VELOCITY

One of the most fundamental relationships in macroeconomics is that between money and income. Whether expressed as a money demand function, a Federal Reserve reaction function, or a quantity-theory equation of exchange, this relationship has been of paramount interest to academics and policymakers alike. In its simplest form the relationship can be summarized as the ratio of income to money. This ratio, called velocity, was orginally used to represent the turnover rate linking money with the total volume of transactions, hence the term transactions velocity. It has since been defined for a number of income measures and for a variety of monetary aggregates. These so-called income velocities have been used to describe how monetary policy relates to income or final demand. The measure used most often is V1, the ratio of GNP to M1.

During most of the post-World War II period, V1 growth remained fairly stable--growing at an average 3 percent annual pace. Another way of stating this is that growth of GNP on average exceeded the growth of money by 3 percent. Unfortunately, starting in late 1981 and continuing through the present period--albeit with a brief hiatus in late 1983 and early 1984--V1 began to diverge significantly, falling sharply below what had come to be its expected growth path. Some economists expected V1 growth to increase and V1 to return to its trend and cautioned that rapid money growth designed to offset the effects of the velocity decline would ultimately prove inflationary. Others believed that velocity growth had permanently declined and warned that failure to offset the drop would lead to subpar economic growth. Clearly, a proper monetary policy depended upon understanding the deviation in velocity growth.

Early studies suggested that the drop in velocity growth in the 1981-1983 period resulted from several factors: an increase in precautionary balances owing to the steepness of two recessions; a sharp drop in inflation and interest rates; and growth in the interest-sensitive component of M1 resulting from deposit deregulation. The 1984-1986 declines in velocity growth were attributed to the further drop in interest rates and to an increase in transactions requiring money balances but not contributing to GNP (such as a rise in imports relative to domestic production and an increase in transactions involving existing finan-

yields is usually a result of tightened monetary policy and a precursor of economic downturns, the current flattening has occurred because of falling long-term rates rather than, as usual, rising short-term rates. In this instance, therefore, the flattening yield curve does not seem to be signalling a tighter monetary policy. Moreover, while real short-term interest rates cial or real assets). Attempts were made to adjust for these changes by redefining both the numerator and the denominator used to calculate velocity. Final demand or income less inventories and net exports was substituted for GNP, and the old definition of M1--currency plus demand deposits--was replaced with one of the newer monetary indexes. Many of these attempts met with limited success, but in the end much of the decline was still unexplained. Of course, this continued uncertainty over the causes and permanence of the velocity shift have made an analysis of current monetary policy highly problematic. It may also have ramifications for fiscal policy. If a less stimulative fiscal policy had the effect of further depressing interest rates and velocity growth, the consequences of large spending cuts might be to weaken economic growth, at least in the near term.



M1 Velocity and Trend

SOURCES: Congressional Budget Office; Federal Reserve Board; Bureau of Economic Analysis, U.S. Department of Commerce.

remain at the very upper edge of their pre-1980 range, they nevertheless have dropped sharply from the high levels of a few years ago.

There is still some risk that velocity growth will rise above its postwar trend rate and recover some of the ground lost since 1981. If that occurred, CBO's forecast of nominal and real GNP could be too low.

## CHAPTER II

# THE BUDGET OUTLOOK

The Congressional Budget Office estimates that the federal government deficit (including off-budget items) will reach a record level of $224 billion in the fiscal year ending September 30, 1986. CBO projects that the fiscal year 1987 deficit would be $184 billion if current taxing and spending policies were continued without change, and $161 billion if the policies of the Congressional budget resolution were fully implemented.

Under the somewhat different assumptions of the Balanced Budget Act, CBO's estimate of the 1987 base deficit as of August 15, 1986, is likely to be about $173 billion. A base deficit of this size would require across-the-board spending reductions of about 8.2 percent for defense programs and 11.5 percent for nondefense programs in order to meet the 1987 deficit target of $144 billion.

In the longer run, the budget outlook suggests slowly shrinking deficits. In the CBO baseline, which assumes current policies, the deficit would decline to $127 billion (2.5 percent of gross national product) by 1989 and to $69 billion (1.2 percent of GNP) by 1991. Implementation of policies of the 1987 Congressional budget resolution would hasten the decline, with the deficit falling to $84 billion in 1989. Further deficit reduction measures would be required, however, to meet the Balanced Budget Act targets, as shown in Figure II-1.

## THE SHORT-RUN BUDGET OUTLOOK

The budget outlook for 1986 and 1987 has worsened since CBO's annual report last February. Legislative action--notably the Consolidated Omnibus Budget Reconciliation Act of 1985 (Public Law 99-272), nicknamed COBRA--has reduced spending and increased taxes. But these Congressional efforts have been more than offset by several unfavorable developments. A shortfall in economic growth has held down revenues, while projected spending for national defense, farm price supports, deposit insurance, and other programs exceeds earlier estimates.

## 1986 Budget Estimates

The CBO estimates that federal government spending will reach $991 billion in 1986--an increase of $5 billion over CBO's February figure (see Table II-1). Estimated revenues for the current fiscal year are $767 billion--a drop of $11 billion since February. As a result, the projected deficit has risen by $16 billion over the past six months. This increase comprises additions of $14 billion from technical estimating changes and $7 billion stemming from revised economic assumptions, minus $5 billion from changes in tax and spending laws.

Economic developments have cut estimated revenues substantially but have had little effect on total 1986 outlays. A sluggish economy and reduced inflation have lowered corporate profits, and the drop in oil prices has cut windfall profit tax receipts, so that estimated 1986 revenues are down by $6 billion. On the outlay side, lower interest rates have held down debt service costs, but lower energy prices have cut offsetting receipts from both

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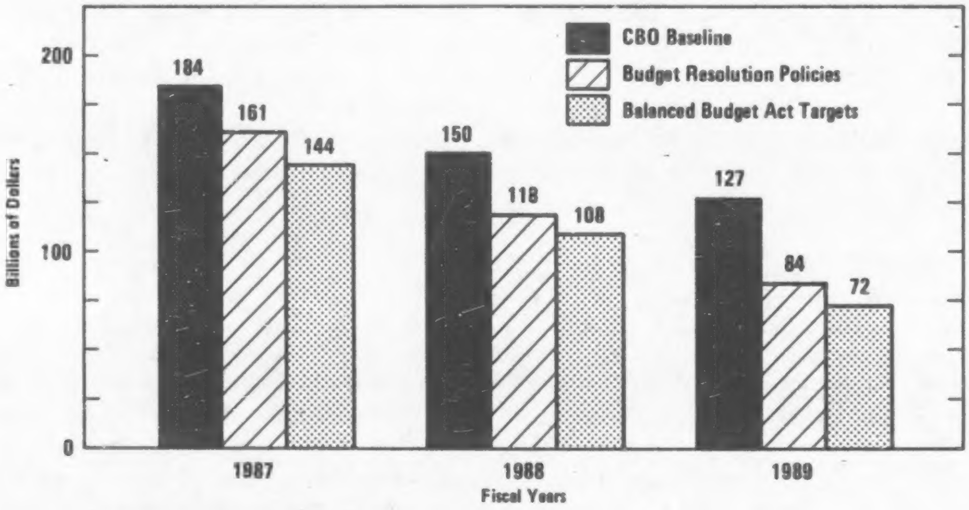
Figure II-1.

Deficit Projections and Targets[a]



SOURCE: Congressional Budget Office.

[a] Includes Social Security, which is off-budget.

onshore and offshore oil and gas production by a slightly larger amount, increasing outlays by a net of $1 billion.

For technical reasons, total spending for a number of programs exceeds the February estimates by $8 billion. The major increases are $5 billion for the Department of Defense and $3 billion for the Federal Deposit Insurance and Federal Savings and Loan Insurance Corporations. Technical revisions have lowered revenues by $6 billion.

## The Budget Outlook for 1987

The Balanced Budget Act of 1985 established a target deficit of $144 billion for fiscal year 1987. Because action on the 1987 budget is not yet complete,

TABLE II-1. THE OUTLOOK FOR FISCAL YEARS 1986 AND 1987
(In billions of dollars)

| | | 1987 | | |
|---|---|---|---|---|
| | 1986 Estimate | CBO Baseline Projection | Base for Balanced Budget Act | Budget Resolution Policies |
| Total, Including Social Security | | | | |
| Outlays | 991 | 1,012 | 1,001 | 995 |
| Revenues | 767 | 828 | 828 | 834 |
| Deficit | 224 | 184 | 173 | 161 |
| On-Budget, Excluding Social Security | | | | |
| Outlays | 807 | 819 | n.a. | 801 |
| Revenues | 567 | 614 | n.a. | 620 |
| Deficit | 240 | 205 | n.a. | 181 |

SOURCE: Congressional Budget Office.

NOTE: n.a. = not applicable.

it is too early to measure precisely the extent to which the projected 1987 deficit might differ from the target. The target can, however, be compared with three different projections:

- The CBO baseline assumes a continutation of budgetary policies now in place. The baseline deficit for 1987 is projected to be $184 billion--$40 billion over the target.
- The Balanced Budget Act defines a slightly different base, which is to be used if 1987 appropriations are not completed. If no appropriations actions are taken, the projected base deficit for sequestration is $173 billion.
- The policies assumed by the Congressional budget resolution imply a deficit of $161 billion.

The conceptual differences between these projections are described below, and their quantitative importance is detailed in Table II-2. Unless otherwise noted, all projections cited here use CBO's economic and technical estimating assumptions.

CBO Baseline. The CBO baseline projection shows where the budget is headed if current taxing and spending policies are continued without change. It is not a prediction of future budgets, which will doubtless include numerous policy changes. Rather it provides a benchmark against which proposed policies can be measured.

Federal spending can be divided into two categories. The first category--mandated by existing law--includes spending for Social Security benefits and other entitlement programs, for permanent appropriations such as interest on the public debt, and for most trust funds and other special funds. For these programs and for revenues, the baseline generally assumes continuation of current law and termination of expiring provisions. Highway and airport and airway taxes, however, are extended beyond their current expiration dates. Federal spending not mandated by existing law is controlled through the appropriation process. The 1987 baseline projection assumes that the 1986 appropriations, including supplemental appropriations, are adjusted to keep pace with inflation.

Base for Balanced Budget Act. Different budgetary assumptions are specified in the Balanced Budget Act for determining whether the law's deficit reduction provisions are triggered. Under the fallback provisions of the act, the Congress will consider across-the-board spending cuts under

TABLE II-2. DIFFERENCES AMONG CBO BASELINE, BASE FOR SEQUESTRATION, AND BUDGET RESOLUTION FOR FISCAL YEAR 1987 (In billions of dollars)

| | Revenues | Outlays | Deficit |
|---|---|---|---|
| CBO Baseline Projection | 828 | 1,012 | 184 |
| Differences | | | |
| Exclusion of discretionary inflation and other adjustments to 1986 appropriation levels | | | |
| Defense programs | -- | -7 | -7 |
| Nondefense programs | -- | -4 | -4 |
| Adjustment in net interest costs | -- | a/ | a/ |
| Total differences | -- | -11 | -11 |
| Base for Balanced Budget Act | 828 | 1,001 | 173 |
| Differences | | | |
| Assumed spending changes | | | |
| Defense programs | -- | 2 | 2 |
| Nondefense programs | -- | -7 | -7 |
| Assumed revenue increases | 6 | -- | -6 |
| Adjustment in net interest costs | -- | -1 | -1 |
| Total differences | 6 | -6 | -12 |
| Budget Resolution Policies | 834 | 995 | 161 |

SOURCE: Congressional Budge Office.

NOTE: Includes Social Security revenues and outlays, which are off-budget.

a. Less than $500 million.

highly expedited procedures if CBO and the Office of Management and Budget (OMB) estimate a 1987 base deficit averaging over $154 billion. Because appropriations for the coming fiscal year have not yet been enacted, the Balanced Budget Act provides that the outlay base assume appropriations at the 1986 dollar level, without adjustment for inflation. The outlay base estimates also include the pay increase allowances for military and federal civilian employees proposed in the Administration's mid-session review of the 1987 budget, which are lower than those in the CBO baseline assumptions. Differences in assumed appropriations cause the outlay base for the Balanced Budget Act to be lower than the baseline by $7 billion for defense programs and $4 billion for nondefense programs. These differences in turn cause the budget base for the Balanced Budget Act to have slightly lower net interest outlays than those in the CBO baseline.

Budget Resolution. On June 26, 1986, the Congress adopted the Concurrent Resolution on the Budget for Fiscal Year 1987 (S. Con. Res. 120). While the precise policy assumptions of the budget resolution are not binding, the budget resolution establishes a plan to guide subsequent Congressional action on revenue and spending legislation. This year's budget resolution assumes revenue increases of $6 billion and spending reductions of $17 billion compared with the updated CBO baseline. Compared with the base for the Balanced Budget Act, the spending reductions in the budget resolution total $6 billion.

## Spending Reductions Under the Balanced Budget Act

The Balanced Budget Act establishes a series of declining deficit targets, culminating in a balanced budget in fiscal year 1991. Both the President's budget submissions and the Congressional budget resolution are required to meet these targets. The deficit target for 1987 is $144 billion. Unless action is actually taken to reduce the deficit to within $10 billion of this target level before the beginning of the fiscal year, the act provides special procedures to achieve the target. Although the Supreme Court has determined that the act's provisions for automatic spending reductions are unconstitutional, the across-the-board reduction of budgetary resources (termed sequestration) remains an option to be used by the Congress under the fallback procedures provided in the law. Alternatively, the Congress may reach the target through another package of deficit reduction measures. Legislation is also pending in the Congress to restore some form of automatic deficit reduction procedures.

The process for fiscal year 1987 begins later this month. On August 20, the Directors of the Congressional Budget Office and the Office of Management and Budget will send the Congress a joint report. The law requires that the report include:

- Estimated budget base levels as of August 15 and the amount by which the projected 1987 deficit exceeds $144 billion;
- CBO and OMB economic assumptions, including their estimates of the rate of real economic growth; and
- The amounts and percentages by which various budgetary resources must be reduced in order to eliminate any deficit excess.

Unless the Balanced Budget Act is amended before August 20, this report will be referred to the Temporary Joint Committee on Deficit Reduction, which is composed of the entire membership of the House and Senate Committees on the Budget. Within five days of the end of the Congressional recess on September 8, the Joint Committee shall report a joint resolution providing for the sequestration of budgetary resources exactly as specified in the CBO/OMB report. A vote on final passage of the joint resolution shall be taken within five days after it is reported. No amendment to the resolution may be considered, and debate is limited to two hours. If enacted, the joint resolution would constitute an initial sequestration order, which would withhold budgetary resources at the start of the fiscal year on October 1.

On October 6, OMB and CBO will issue a revised report on the estimated deficit for fiscal year 1987 and any spending reductions required to eliminate the deficit excess as then calculated. This revised report will reflect any changes in laws or regulations made since August 15. Without a change in the Balanced Budget Act procedures, the Congress will consider the revised report under the same procedures outlined above. If adopted as a joint resolution and approved by the President, the revised report would constitute a final sequestration order, which would permanently cancel budgetary resources.

The CBO currently estimates that the base deficit for 1987 is $173 billion and that the excess deficit is $29 billion. The August 20 estimate will differ from this amount if new budgetary legislation is enacted (for example, the pending reconciliation bill) or if the Administration promulgates final regulations changing spending policies (for example, the elimination of periodic interim payments under Medicare, recently issued as a Notice of Proposed Rulemaking). Even without any policy changes, the deficit estimate could change, based on new information about economic or budgetary developments. Finally, the deficit amount in the report to the Congress will be an average of CBO and OMB estimates, not the CBO estimate alone.

## THE BUDGET OUTLOOK THROUGH 1991

The CBO has updated its baseline budget projections for fiscal years 1987 through 1991 to reflect legislation enacted since February as well as CBO's new economic and technical estimating assumptions. It has also reestimated the Congressional budget resolution for fiscal years 1987 through 1989 to put it on a consistent basis with the updated baseline. The following sections describe first the updated CBO baseline and then CBO's projections of the deficit under the policies of the budget resolution.

### CBO Baseline

Table II-3 details CBO's updated baseline projections. Under current budgetary policies, the federal government deficit would decline from $224 billion (5.4 percent of GNP) in 1986 to $184 billion (4.2 percent of GNP) in 1987 and $69 billion (1.2 percent of GNP) by 1991. Outlays would decline relative to GNP because the baseline generally assumes no real growth in spending, while the economy is assumed to grow about 3 percent per year in real terms. Revenues would grow faster than the economy because of scheduled increases in social insurance contributions, and because economic growth pushes individual income taxpayers into higher tax brackets. (The tax rate structure is indexed for inflation but not for real growth.) It is also assumed that the share of corporate profits subject to tax will increase.

The on-budget and off-budget components of federal spending and revenues are shown separately in Table II-4. The Balanced Budget Act of 1985 removed from the budget totals the two Social Security trust funds--Old-Age, Survivors, and Disability Insurance (OASDI). The table shows that Social Security is projected to run surpluses each year, and that the surplus will grow by $64 billion between 1986 and 1991. The projected decline in the on-budget deficit is, therefore, much less than the drop in the total deficit. Nevertheless, the total deficit is used in calculating the excess deficit amount under the Balanced Budget Act. The total deficit also provides a better measure of the federal government's effect on the economy and on credit markets.

TABLE II-3. UPDATED CBO BASELINE PROJECTIONS FOR FISCAL YEARS 1986-1991

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| | **In Billions of Dollars** | | | | | |
| Revenues | | | | | | |
| Individual income | 349 | 381 | 421 | 458 | 496 | 535 |
| Corporate income | 62 | 76 | 92 | 103 | 112 | 123 |
| Social insurance | 284 | 301 | 332 | 356 | 387 | 417 |
| Other | 72 | 71 | 71 | 70 | 72 | 74 |
| Total | 767 | 828 | 915 | 987 | 1,067 | 1,148 |
| Outlays | | | | | | |
| Defense | 273 | 284 | 295 | 310 | 325 | 341 |
| Entitlements | 457 | 467 | 499 | 527 | 558 | 593 |
| Nondefense discretionary | 172 | 173 | 183 | 190 | 197 | 206 |
| Net interest | 137 | 139 | 147 | 151 | 150 | 149 |
| Offsetting receipts | -48 | -51 | -59 | -64 | -67 | -72 |
| Total | 991 | 1,012 | 1,065 | 1,113 | 1,162 | 1,217 |
| Deficit | 224 | 184 | 150 | 127 | 96 | 69 |
| Debt Held by the Public | 1,739 | 1,924 | 2,071 | 2,195 | 2,290 | 2,358 |
| | **As a Percent of GNP** | | | | | |
| Revenues | | | | | | |
| Individual income | 8.4 | 8.6 | 8.9 | 9.0 | 9.1 | 9.1 |
| Corporate income | 1.5 | 1.7 | 1.9 | 2.0 | 2.1 | 2.1 |
| Social insurance | 6.8 | 6.8 | 7.0 | 7.0 | 7.1 | 7.1 |
| Other | 1.7 | 1.6 | 1.5 | 1.4 | 1.3 | 1.3 |
| Total | 18.4 | 18.7 | 19.2 | 19.3 | 19.5 | 19.5 |
| Outlays | | | | | | |
| Defense | 6.6 | 6.4 | 6.2 | 6.1 | 5.9 | 5.8 |
| Entitlements | 11.0 | 10.6 | 10.5 | 10.3 | 10.2 | 10.1 |
| Nondefense discretionary | 4.1 | 3.9 | 3.9 | 3.7 | 3.6 | 3.5 |
| Net interest | 3.3 | 3.1 | 3.1 | 3.0 | 2.7 | 2.5 |
| Offsetting receipts | -1.2 | -1.2 | -1.2 | -1.2 | -1.2 | -1.2 |
| Total | 23.8 | 22.9 | 22.4 | 21.8 | 21.2 | 20.7 |
| Deficit | 5.4 | 4.2 | 3.2 | 2.5 | 1.7 | 1.2 |
| Debt Held by the Public | 41.8 | 43.5 | 43.6 | 43.0 | 41.8 | 40.1 |
| Memorandum: GNP (In billions of dollars) | 4,164 | 4,423 | 4,753 | 5,102 | 5,477 | 5,876 |

SOURCE: Congressional Budget Office.

NOTE: Includes Social Security revenues and outlays, which are off-budget.

The baseline budget deficit for 1987 has increased slightly since CBO's February assessment, but the outlook for subsequent years has improved. This pattern of changes results primarily from revisions to the economic assumptions. Economic reestimates add $3 billion to the 1987 deficit, as lower interest rates and cost-of-living adjustments fail to offset completely the effect of lower revenues. Lower interest rates and higher ratios of taxable incomes to GNP, however, combine to reduce the deficit by amounts growing from $12 billion in 1988 to $35 billion by 1991. Recently enacted legislation, primarily COBRA, has reduced the baseline deficit by an average of $13 billion per year in the 1987-1991 period, but technical estimating changes have added back almost as much. Table II-5 apportions the changes in CBO's baseline projections since February among the three major sources of difference--enacted legislation, revised economic assumptions, and technical reestimates.

TABLE II-4. CBO BASELINE PROJECTIONS FOR ON-BUDGET AND OFF-BUDGET SPENDING AND REVENUES
(By fiscal year, in billions of dollars)

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| Baseline Revenues | | | | | | |
| On-budget | 567 | 614 | 673 | 722 | 776 | 833 |
| Off-budget (OASDI) a/ | 200 | 213 | 242 | 264 | 290 | 316 |
| Total | 767 | 828 | 915 | 987 | 1,067 | 1,148 |
| Baseline Outlays | | | | | | |
| On-budget | 807 | 819 | 864 | 901 | 939 | 981 |
| Off-budget (OASDI) a/ | 184 | 193 | 202 | 212 | 223 | 236 |
| Total | 991 | 1,012 | 1,065 | 1,113 | 1,162 | 1,217 |
| Baseline Deficit (-) or Surplus | | | | | | |
| On-budget | -240 | -205 | -191 | -179 | -163 | -148 |
| Off-budget (OASDI) a/ | 16 | 21 | 41 | 53 | 67 | 80 |
| Total | -224 | -184 | -150 | -127 | -96 | -69 |

SOURCE: Congressional Budget Office.

a. OASDI = Old-Age, Survivors, and Disability Insurance.

Revenues. Projected revenues for 1987 have been lowered by $16 billion, principally as a result of downward revisions in incomes, especially corporate profits. Projected revenues for 1988 through 1990 are also lower

TABLE II-5. CHANGES FROM CBO FEBRUARY BASELINE PROJECTIONS (By fiscal year, in billions of dollars)

| | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|
| **Revenues** | | | | | | |
| CBO February Baseline | 778 | 844 | 921 | 991 | 1,068 | 1,144 |
| Enacted legislation | 1 | 3 | 3 | 3 | 3 | 3 |
| Revised economic assumptions | -6 | -16 | -8 | -4 | a/ | 6 |
| Technical reestimates | -6 | -3 | -1 | -4 | -4 | -4 |
| Updated Baseline | 767 | 828 | 915 | 987 | 1,067 | 1,148 |
| **Outlays** | | | | | | |
| CBO February Baseline | 986 | 1,025 | 1,086 | 1,135 | 1,188 | 1,248 |
| Enacted legislation | -4 | -10 | -8 | -10 | -13 | -14 |
| Revised economic assumptions | 1 | -12 | -19 | -20 | -24 | -29 |
| Technical reestimates | 8 | 9 | 6 | 9 | 12 | 12 |
| Updated Baseline | 991 | 1,012 | 1,065 | 1,113 | 1,162 | 1,217 |
| **Deficit** | | | | | | |
| CBO February Baseline | 208 | 181 | 165 | 144 | 120 | 104 |
| Enacted legislation | -5 | -12 | -10 | -13 | -15 | -16 |
| Revised economic assumptions | 7 | 3 | -12 | -17 | -25 | -35 |
| Technical reestimates | 14 | 12 | 7 | 12 | 15 | 16 |
| Updated Baseline | 224 | 184 | 150 | 127 | 96 | 69 |

SOURCE: Congressional Budget Office.

NOTE: Includes Social Security revenues and outlays, which are off-budget.

a. Less than $500 million.

than in February--by $6 billion in 1988, $5 billion in 1989, and $1 billion in 1990. By 1991, taxable personal and corporate incomes are estimated to claim higher shares of GNP than projected in February, raising revenues above CBO's February estimate. Including the effects of new legislation and technical reestimates, 1991 revenues rise by $5 billion despite the overall downward revision in GNP.

Two laws that have been enacted since February have an important effect on revenues. The Consolidated Omnibus Budget Reconciliation Act of 1985 will increase revenues by about $3 billion per year, mostly through an increase in cigarette taxes, extension of Medicare coverage to newly hired state and local employees, and the disallowance of income averaging to taxpayers who have recently been students. The Federal Employees' Retirement System Act of 1986 (Public Law 99-335) will reduce baseline revenues each year, by amounts ranging up to $600 million in 1991.

Technical reestimates lower revenues by $1 billion to $4 billion per year. The largest technical reestimate occurs in individual income taxes--the major tax source, which provides 46 percent of revenues. A significant component of this reestimate results from a reduction in expected revenues from taxing Social Security benefits.

When economic, legislative, and technical revisions are considered together, the economic revisions predominate and determine the character of the overall revisions. The largest economic revisions occurred in corporate income taxes, which are lower by $12 billion in 1987 and by diminishing amounts in 1988 and 1989. By 1991, however, higher projected taxable income raises corporate taxes by $9 billion relative to February, despite the lower GNP. The taxable share of corporate profits is projected to grow over time, mostly because a larger share of corporate income is earned domestically, not abroad. In addition, depreciation deductions are assumed to remain flat rather than rise. Individual income tax revisions are relatively small because higher taxable income shares more than offset the lower GNP until 1990 when taxable personal income first falls below February's estimate. Finally, no new windfall profit tax liability is projected for 1987 through 1991 because of lower projected oil prices. This change reduces net revenues by about $1 billion each year.

Outlays. Projected outlays have declined since February by amounts growing from $13 billion in 1987 to $31 billion by 1991 resulting, largely from changes in economic assumptions. Enacted legislation has cut spending by about $11 billion annually. Almost all of this decrease is a result of COBRA, which terminated General Revenue Sharing, provided for the release from escrow of disputed Outer Contintental Shelf (OCS) receipts, and reduced Medicare payments. Other recent legislation, including supplemental appropriations and civilian and military retirement reform, have had little aggregate effect.

The revisions to the economic assumptions have reduced spending by $12 billion in 1987, with reductions growing to $29 billion by 1991. The major reductions are in net interest and other interest-sensitive programs ($8 billion in 1987 and $15 billion in 1991), cost-of-living adjustments for indexed benefit programs ($6½ billion in 1987 and $12 billion in 1991), and federal civilian and military pay raise allowances ($½ billion in 1987 and $3 billion in 1991). These reductions are offset slightly by lower receipts from both onshore and offshore oil and gas production.

Technical reestimates raise outlays in all years. New information from the Federal Deposit Insurance Corporation (FDIC) indicates that the rescue of insolvent financial institutions will cost $4 billion per year more than previously estimated. Projected outlays for farm price supports have been increased by between $1 billion to $3 billion per year--an increase caused largely by a delay in the anticipated improvement in export markets and the resulting reductions in planned inventories. The technical reestimates to outlays and revenues also cause an increase in debt service costs amounting to $1 billion in 1987, $2 billion in 1988, and $4 billion by 1991.

## Congressional Budget Resolution

Implementing the policies of the Congressional budget resolution would reduce the federal deficit by $23 billion in 1987, $32 billion in 1988, and $43 billion in 1989 compared with the CBO baseline. Reconciliation instructions require particular House and Senate committees to achieve $9 billion of these savings in 1987, $7 billion in 1988, and $10 billion in 1989. The remainder of the savings is to be achieved through the appropriation process and other legislation.

The policy changes in the budget resolution are summarized in Table II-6. The table assumes that no use is made of the resolution's contingency fund for deficit reduction and unmet critical needs. Unspecified revenue increases would reduce the deficit by $6 billion to $7 billion per year. Defense outlays would be reduced by $5 billion in 1987, $10 billion in 1988, and $12 billion in 1989.

Outlays for entitlement programs would differ very little from the baseline. Under current law, beneficiaries of Social Security and related programs will not receive a cost-of-living adjustment next January, because inflation since the last adjustment will not exceed 3 percent. The budget resolution proposes to eliminate the 3 percent trigger, thereby increasing entitlement spending by $2 billion in 1987 and $1 billion in 1988. Reductions in Medicare would save $1 billion in 1988 and $2 billion in 1989. Other assumed changes in entitlements total less than $1 billion per year.

The budget resolution reduces nondefense discretionary spending by $7 billion in 1987, $10 billion in 1988, and $17 billion in 1989. Budget functions facing particularly large cuts include international affairs, science and space, and transportation.

The budget resolution assumes increases in offsetting receipts totaling $5 billion in 1987 and $3 billion in 1988. The 1987 increase includes $1.9 billion for the sale of Conrail, $1.2 billion for the recoupment of oil

TABLE II-6. POLICY CHANGES IN THE 1987 BUDGET RESOLUTION AS ESTIMATED BY CBO (By fiscal year, in billions of dollars)

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| CBO Baseline Deficit | 184 | 150 | 127 |
| Deficit Reductions as Estimated by CBO | | | |
| Revenue increases a/ | -6 | -6 | -7 |
| National defense | -5 | -10 | -12 |
| Entitlements | 1 | b/ | -2 |
| Nondefense discretionary | -7 | -10 | -17 |
| Offsetting receipts | -5 | -3 | b/ |
| Net interest | -1 | -3 | -5 |
| Total reductions | -23 | -32 | -43 |
| Deficit in Budget Resolution as Estimated by CBO | 161 | 118 | 84 |

SOURCE: Congressional Budget Office.

NOTE: Includes Social Security revenues and outlays, which are off-budget.

a. Revenue increases appear as negative numbers because they reduce the deficit.

b. Less than $500 million.

overcharge funds, and $1 billion from sale of unspecified loan assets. The 1988 target includes $1.5 billion from sale of the Naval Petroleum Reserves and another $1 billion from unspecified loan asset sales. There are no offsetting receipt savings in 1989 because the assumed sales of Conrail and the Naval Petroleum Reserves and the assumed reductions in federal agency contributions for employee retirement reduce receipts by more than the small increases from additional loan asset sales and user fees.

The CBO estimates that deficits under the policies of the Congressional budget resolution will be higher than those specified in the resolution itself, especially in 1987. As shown in Table II-7, CBO reestimates add $18 billion to the budget resolution deficit in 1987. Economic factors add $9 billion to the budget resolution deficit in 1987, but reduce the deficits by $3 billion and $8 billion in 1988 and 1989, respectively. Technical reestimates add to the deficits in all years.

TABLE II-7. CBO REESTIMATES OF THE BUDGET RESOLUTION
(By fiscal year, in billions of dollars)

| | 1987 | 1988 | 1989 |
|---|---|---|---|
| Deficit in Budget Resolution | 143 | 116 | 78 |
| CBO Economic Reestimates | | | |
| Revenues | 16 | 8 | 4 |
| Net interest | -7 | -9 | -8 |
| Other | a/ | -2 | -3 |
| Subtotal | 9 | -3 | -8 |
| CBO Technical Reestimates | 10 | 6 | 13 |
| Total reestimates | 18 | 2 | 6 |
| Deficit in Budget Resolution as Estimated by CBO | 161 | 118 | 84 |

SOURCE: Congressional Budget Office.

NOTE: Includes Social Security revenues and outlays, which are off-budget.

a. Less than $500 million.

With a few exceptions, the economic and technical reestimates to the budget resolution are the same as the reestimates to the CBO baseline, discussed in detail earlier. The economic reestimates differ from those in the resolution largely because of different assumptions about cost-of-living adjustments and about federal employee pay raises. During its work on the budget resolution, the Congress assumed--based on economic developments since February--that the January 1987 cost-of-living adjustment (COLA) for Social Security and related programs would be 2.0 percent, instead of the 3.4 percent assumed in CBO's February baseline. CBO now estimates that the January 1987 COLA under the policies of the budget resolution will be 1.3 percent. Reestimates to the budget resolution, therefore, reflect a reduction in the 1987 Social Security COLA from 2.0 percent to 1.3 percent. Because under current law no COLA is paid when inflation is less than 3 percent, the reestimates to the baseline reflect a reduction from 3.4 percent to zero. This difference in COLA assumptions adds $5 billion to the economic reestimates in 1987 and 1988 and $4 billion in 1989.

The other major difference in the economic reestimates concerns assumptions about pay raises for federal employees. In the baseline, federal pay is assumed to keep pace with private wage rates. Because private-sector earnings are now projected to be growing less rapidly than they were in February, the baseline has been reduced accordingly. But no adjustments to pay raises have been made for the budget resolution, which assumes pay raise allowances that are fixed in dollar terms. This second difference causes the reestimates to the budget resolution to exceed the baseline reestimates by $1 billion in 1987, $3 billion in 1988, and $4 billion in 1989.

Technical reestimates of the budget resolution for both revenues and outlays are generally identical to CBO's technical adjustments to the baseline. The major exception is for defense spending, for which the budget resolution outlays are a target to be achieved through appropriation action and, therefore, have not been reestimated.

## Federal Sector of the National Income and Product Accounts

Both the budget and the federal sector of the national income and product accounts (NIPA) measure the receipts and expenditures of the federal government. The NIPA federal sector, however, is designed to be more useful than the budget for analyzing the economic impact of federal government activity. The NIPA estimates of federal government activity differ from those of the budget in timing, treatment of receipts and financial activities, and coverage. Table II-8 shows estimates of federal-sector receipts on a NIPA basis, consistent with the CBO baseline budget projections.

TABLE II-8. PROJECTIONS OF CBO BASELINE RECEIPTS AND EXPENDITURES ON A NATIONAL INCOME AND PRODUCT ACCOUNTS BASIS (By fiscal year, in billions of dollars)

|  | 1986 Estimate | Baseline Projection |  |  |  |  |
|---|---|---|---|---|---|---|
|  |  | 1987 | 1988 | 1989 | 1990 | 1991 |
| Receipts |  |  |  |  |  |  |
| Personal tax and nontax receipts | 354 | 382 | 423 | 458 | 497 | 536 |
| Corporate profits tax accruals | 75 | 94 | 111 | 121 | 132 | 141 |
| Indirect business tax and nontax accruals | 53 | 52 | 52 | 53 | 54 | 56 |
| Contributions for social insurance | 326 | 347 | 385 | 419 | 452 | 486 |
| Total | 808 | 875 | 972 | 1,051 | 1,135 | 1,219 |
| Expenditures |  |  |  |  |  |  |
| Purchases of goods and services | 369 | 376 | 393 | 413 | 432 | 452 |
| Defense | 276 | 289 | 301 | 316 | 332 | 349 |
| Nondefense | 93 | 87 | 92 | 97 | 100 | 103 |
| Transfer payments | 390 | 403 | 431 | 460 | 492 | 528 |
| Grants-in-aid to state and local governments | 103 | 102 | 105 | 109 | 114 | 119 |
| Net interest paid | 138 | 141 | 149 | 152 | 151 | 149 |
| Subsidies less current surplus of government enterprises | 24 | 25 | 31 | 28 | 29 | 29 |
| Total | 1,024 | 1,045 | 1,108 | 1,163 | 1,217 | 1,277 |
| Deficit | 216 | 170 | 136 | 112 | 82 | 58 |

SOURCE: Congressional Budget Office.

TABLE II-9. RELATIONSHIP OF THE BUDGET TO THE FEDERAL SECTOR OF THE NATIONAL INCOME AND PRODUCT ACCOUNTS (By fiscal year, in billions of dollars)

| | 1986 | Baseline Projection | | | | |
|---|---|---|---|---|---|---|
| | Estimate | 1987 | 1988 | 1989 | 1990 | 1991 |
| | | | | **Receipts** | | |
| Total Revenues a/ | 767 | 828 | 915 | 987 | 1,067 | 1,148 |
| Contributions for Employee Retirement | 34 | 37 | 44 | 48 | 52 | 56 |
| Medicare Premiums | 6 | 6 | 7 | 8 | 9 | 9 |
| Other Netting and Grossing | 8 | 8 | 8 | 8 | 8 | 9 |
| Geographic Exclusions | -2 | -2 | -2 | -2 | -2 | -2 |
| Other | -5 | -1 | -1 | 1 | 1 | -1 |
| Federal Sector NIPA Receipts | 808 | 875 | 972 | 1,051 | 1,135 | 1,219 |
| | | | | **Expenditures** | | |
| Total Outlays a/ | 991 | 1,012 | 1,065 | 1,113 | 1,162 | 1,217 |
| Lending and Financial Transactions | -12 | -14 | -14 | -11 | -10 | -9 |
| Contributions for Employee Retirement | 34 | 37 | 44 | 48 | 52 | 56 |
| Medicare Premiums | 6 | 6 | 7 | 8 | 9 | 9 |
| Other Netting and Grossing | 8 | 8 | 8 | 8 | 8 | 9 |
| Defense Timing Adjustment | 3 | 3 | 3 | 3 | 3 | 3 |
| Bonuses on Outer Continental Shelf Land Leases | 2 | 2 | b/ | b/ | b/ | b/ |
| Geographic Exclusions | -6 | -6 | -6 | -6 | -7 | -7 |
| Other | -2 | -2 | -1 | -1 | -1 | -2 |
| Federal Sector NIPA Expenditures | 1,024 | 1,045 | 1,108 | 1,163 | 1,217 | 1,277 |

SOURCE: Congressional Budget Office.

a. Includes on-budget and off-budget activities.

b. Less than $500 million.

Certain payments that appear as offsets to outlays in the budget are treated as receipts in the federal sector of the NIPA. Of these payments, by far the largest is contributions to employee retirement. Financial transactions, such as bonuses on OCS land leases and loan asset sales, are excluded from the NIPA federal sector, as are transactions involving Puerto Rico and other territories. One timing difference involves corporate profits. The unified budget records corporate profit taxes at the time payments are made, while the NIPA records them when they accrue. Also, NIPA defense purchases reflect the delivery of completed products, while the budget shows payments to contractors, including payments for work-in-progress.

The differences between the budget and the federal sector of the NIPA are detailed in Table II-9. Since CBO's February baseline projections, estimates of contributions for employee retirement have increased substantially, reflecting the adoption of retirement reform legislation. Employee contributions to the new thrift plan combine with increases in agency contributions to the adjustment relative to its February level. Higher lending exclusions mainly reflect increases in FDIC spending, while lower oil price assumptions reduce bonuses on OCS leases, as discussed above.

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